



UNIVERSITY OF CAPE TOWN, FACULTY OF LAW – SCHOOL FOR ADVANCED
LEGAL STUDIES

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MTNSIM011

Master of Laws (Commercial) Coursework and Minor Dissertation.

**The Introduction of Islamic Banking and its Projected Impact on Financial Inclusion
and Economic Development in Uganda.**

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Word Count: **22707**

Dissertation presented for the approval of Senate in fulfillment of part of the requirements for LLM (Commercial) Coursework and a minor dissertation. The other part of the requirement for this qualification was the completion of a programme of courses.

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Simon Mutungi Muhairwe

Date: 11th September, 2017

Dedication

This research is dedicated to Joy Arinaitwe Karisa. A sister, mother and best friend. She lives in the great beyond but I am grateful to God for all she was. Your life was blessing, your memory a treasure, you are loved beyond words and missed beyond measure. I also dedicate this to the 80 per cent of the global population living below the poverty line.

ACKNOWLEDGEMENT

First and foremost, praise galore and thanks to the Almighty good Lord, for His showers of blessings throughout my life, career and for seeing me through this research. **He's graced me with opportunities that I know are not of my hand or any other human hand.**

I would also like to express my sincere gratitude to my supervisor, Ms. Silindile Buthelezi, for all her time, wisdom, inspiration, patience and understanding. Her encouragement, support, criticism and comments have been invaluable and most helpful throughout the time of this thesis. She has taught me the methodology to carry out the research and to present the research works as clearly as possible. It was a great privilege and honor to work and study under her guidance. I am extremely grateful for what she has offered me and may she be blessed.

I am eternally grateful to my parents Mr. Frank and Mrs. May Owoyesigire who have ensured that my dreams stay valid. I extend gratitude to my siblings Paul and Mark for the emotional support. My relatives Koy, Robert, Ann, Peace, Alice, Bob, Anolyn, Philemon, Anglyn, Allan, Patience, Phil and everyone who has been there from the beginning. My friends Arnold, Franklin, Maurice, KBwana, Murungi, Hope, Idoot, Dr. Kakooza, Nyehita, Meshack, Jovenal, Anita, Pearl, Katie, Judith, Joryne, Richard, Suzan, Norman, Dixon, Silver, Linda, Elaine, Irene, Connie, Clare, Jojo, Latiela and others. The courage and significance you give me every day I go out the door is unparalleled. Am grateful.

Table of Contents

Abstract	6
CHAPTER ONE	7
1. Research Background	7
1.1 Problem Statement	9
1.2 Research Aims and Objectives	13
1.3 Methodology	14
1.4 Overview of Chapters	15
CHAPTER TWO	17
2. THE EVOLUTION OF FINANCIAL INSTITUTIONS IN UGANDA AND THE STATUS OF THE ECONOMY AND FINANCIAL INCLUSION.	17
2.1 Background and Evolution Of The Banking Sector In Uganda	17
2.1.1 Pre-Independence Era	17
2.1.2. Post-Independence Era; A Nascent Banking Sector	19
2.1.3. A New Dawn: Bank And Economic Reform	21
2.1.4. Distress In The Banking Sector	22
2.2. Status Of The Economy And Financial Inclusion In Uganda	24
2.2.1. Gapping Inequality And Financial Exclusion	24
2.2. Key Challenges Encountered By Government In Accelerating Shared Prosperity Through Financial Inclusion.	26
CHAPTER THREE	30
3. THE DEVELOPMENT OF ISLAMIC FINANCE AND ITS PROJECTED IMPACT ON INCLUSIVE ECONOMIC GROWTH IN UGANDA	30
3.1. Evolution of Islamic Banking	30
3.1.1 Current Status Of Islamic Banking At The Global Stage	31
3.2. Principles Of Islamic Banking As Catalyst For Inclusive Economic Growth	31
3.2.1. Transactions Or Products Prohibited Under Islamic Finance	32
Haram	32
Speculation/Chance	33
Interest/Riba	35

3.2.2.	Islamic Finance Modes and Their Projected Implication on Uganda's Economy.	39
	Profit and Loss Sharing	39
	Mudaraba/ Partnership financing	40
	Musharaka / Equity based finance	41
	Murabaha/ Sale based financing	42
3.2.3.	Islamic windows	45
	CHAPTER FOUR	47
4.	LEGISLATIVE FRAMEWORK AND CHALLENGES OF ISLAMIC BANKING IN UGANDA	47
4.1.	Institutional Framework and Supervisory Bodies	47
	The Bank of Uganda	47
	The Basel Committee on Banking Supervision (BCBS)	48
	The Islamic Financial Services Board (IFSB)	48
4.2.	Legislative Challenges For Islamic Bank In Uganda	49
4.2.1.	The Financial Institutions Amendment Act 2016	50
4.2.2.	The Legal Concept of goods	57
4.2.3.	Double taxation with respect to sales modes transactions	58
4.2.4.	Jurisdiction of the Court in Uganda in Islamic banks disputes	59
	CHAPTER FIVE	60
5.	RECOMMENDATIONS AND CONCLUSION;	60
5.1.	Lessons from Malaysia.	60
5.1.1.	Liquidity Measurement Adjustments	60
5.1.2.	Application of Alternative Dispute Resolution	62
5.1.3.	Exemption from Double Taxation	63
5.1.4.	Separate Deposit Protection Fund	64
5.1.5.	Twin Peaks model of financial regulation.	65
5.2.	Conclusion: Uganda, An Aspiring Dual System.	66

Abstract

Islamic banks were minimally affected by the global financial crisis of 2008. This is largely attributed to their firm and sound economic principles. This has made Islamic finance a feasible alternative system of banking especially in pursuit of financial inclusion.

Uganda like most third world countries has grappled with the challenge of access to credit with a big unbanked population. One of the reasons espoused in this paper for this problem has been high cost of credit access caused by prohibitively high interest rates that discourage people from attaining loans for their entrepreneurial ventures. Since Islamic banking is an interest free based mode of finance, it could have the key to unlocking the door to an inclusive economy.

However, there is a desire for dedicated research and efforts from the authorities to develop an effective legal and regulatory framework for Islamic financial industry in Uganda.

Attempts should be made to modify the existing structure to provide better products and quality service within the ambit of Islamic laws. While interest based banking has taken hundreds of years to mature to the level where it is today, expecting the same maturity from Islamic banking in its nascent stage will be overly ambitious. To develop an economic system truly reflective of the sacred principles of Islam, all stakeholders should understand the limitations at this stage and work towards its advancement.

CHAPTER ONE

1. Research Background

This Chapter gives an overview of the research, the problem, motivation for the study, objectives and accordingly provides background to contextualize the study.

Before the introduction of Islamic banking, Uganda's economy has in recent times like any other, experienced growths and declines. The Gross Domestic Product (GDP) estimates for the fiscal year (FY) 2015/16 indicate that the economy grew by 4.8 per cent, which is 0.3 percentage points lower than the growth of 5.1 per cent achieved in the FY 2014/15.¹ Although this was a slowdown in the growth of GDP, it is nevertheless a good performance given that the global economy faced adverse shocks during 2015/16. In regard to public spending, the Government released funds but actual implementation of projects remained low as some of the budgeted money went unspent.²

The incumbent government (National Resistance Movement) in Uganda has since 1987 embarked on liberalizing the economy through privatization which subsequently led to growth in the private sector.³ This sector however needs access to finances, short of which it is likely to crumble. The main objective of economic development is not only to boost economic growth but also to share prosperity with all segments of society through equitable distribution of wealth and income, ergo for a country to attain healthy economic development, it must have a sound financial inclusion status.⁴

The status of financial inclusion has overtime improved with an overall, 85 per cent of the adult population aged 16 years and above being financially included, an improvement

¹ Uganda Bureau Of Statistics (UBOS) Statistical Abstract 2016. Available at http://www.ubos.org/onlinefiles/uploads/ubos/statistical_abstracts/2016%20Statistical%20Abstract.pdf accessed on May 30, 2017.

² For example; According to Uganda's Budget Monitoring and Accountability Unit, a total of two hundred forty three billion Ugandan shillings accounting for 24.1 percent of the released budget to the health sector was not spent. http://www.newvision.co.ug/new_vision/news/1424773/todays-vision-2016

³ Augustus Nuwagaba, 'Globalization and Competitiveness; Implications for poverty reduction in Uganda.' *Michigan State University Journal of social development in Africa* Vol 16. No 2 2001 at page 37.

⁴ Asian Development Bank Institute. *Financial System Stability, Regulation, and Financial Inclusion*. SPRINGER Verlag, JAPAN, 2016.

from 70 percent in 2009 and 38 per cent in 2006.⁵ The improvement in formal inclusion between 2009 and 2013 was largely inspired by mobile money services whose accounts now stand at 55 per cent.⁶ The percentage of the banked population though stable, is still low ranging between 18-21 per cent while formal inclusion is widespread urban areas compared to rural areas.⁷ This lack of inclusive growth is exacerbated by the appalling rate of economic inequality prevailing through the country.⁸ Access to credit is more difficult to attain in rural areas than it is in urban places as banks and other institutions have shied away from the former segment of society.⁹

The population has mainly shied away from banks because of their increasingly strict terms for borrowing caused by worsening quality of loans that had trimmed private sector credit by 1.6 per cent by September 2016, compared to the corresponding period of 2015.¹⁰ As at the end of June 2016, commercial bank lending rates averaged 23.54 per cent and banks have come under pressure for giving prohibitively high rates to the private sector.¹¹ Although as of April 2017, the BOU had reduced the Central Bank Rate (CBR) by 0.5 per cent points to 11 per cent¹², this still remains a relatively high figure that will consequently force the conventional commercial banks to charge a higher interest rate to the public that wishes to obtain credit. There is clearly need for further reduction in interest rates charged by the banks and this is where the unconventional-interest-free Islamic banking enters the equation. Islamic finance prohibits the charging of ‘*riba*’ (interest).¹³ The

⁵ Bank of Uganda Report on the status of Financial Inclusion 2014. Available at https://www.bou.or.ug/bou/bou-downloads/Financial_Inclusion/Report-on-the-State-of-Financial-Inclusion-First-Edition-March-2014.pdf. Accessed on September 4, 2017.

⁶ Uganda Bureau of Statistics op cit (n1).

⁷ The 2014 Global Findex Report. Available at http://datatopics.worldbank.org/financialinclusion/Infographics/WB_GlobalFindex_GlobalInfographic_0406_final.pdf. Accessed on May 29, 2017.

⁸ Oxfam Uganda Inequality Report, 2017, ‘*Who is Growing? Ending Inequality in Uganda*’ Report available at https://www.oxfam.org/sites/www.oxfam.org/files/file_attachments/oxfam_in_uganda_inequality_report_compressed.pdf last accessed on May 30, 2017. Oxfam Uganda.

⁹ Simon Mutungi Muhairwe, ‘Key challenges faced by government in deepening financial inclusion in Uganda’. *Uganda Bankers Conference inaugural conference magazine* July 2017.

¹⁰ Global Findex Report op cit (n 7).

¹¹ Mark Keith Muhumuza, ‘Why Uganda’s interest rates stubbornly remain high’ *The Daily Monitor Newspaper* published on August 9, 2016.

¹² Bank of Uganda Monetary Policy for April 2017.

¹³ “Those who charge *riba* are in the same position as those controlled by the devil’s influence...as for those who persist in *riba*, they incur hell, wherein they abide forever” –*Qur’an* 2; 275

rationale behind the prohibition of *riba* on consumption loans is to redistribute the purchasing power from the rich to the poor.¹⁴ This is because it is assumed that those who borrow are seeking to maintain some minimum standard of living and as such to make a profit off them is against the spirit of charity.¹⁵ Therefore those with high income are requested to make loans to the less advantaged without having to extract *riba* from them. Reducing the economic gap between the two factions could thus eliminate inequality and subsequently financial exclusion.

1.1 Problem Statement

Islamic banking sector is the dominant component of Islamic finance and it is a rapidly growing part of the global financial sector with this growth trend projected to continue.¹⁶ This type of banking is based on *Shari'ah* law. There is a global surge of states and business persons dealing or seeking to invest in Islamic banking and finance.¹⁷ This is mainly attributed to readily steady domestic and foreign markets as well as a myriad business opportunities.¹⁸ This makes it a lucrative business venture and according to the World Bank, global assets held under Islamic finance are approximately 2 trillion US Dollars up from 800 billion US Dollars in 2015 growing at 10-12% annually.¹⁹

The Profit and Loss Sharing²⁰ aspect of Islamic banking is also an alternative to interest based banking for those seeking credit. This is because unlike conventional banks, Islamic banks do not charge interest on principal debts carried out by borrowers.²¹ Before

¹⁴ Noorzoy, M.S. (1982, Feb). Islamic Laws on *Riba* (interest) and their Economic Implications. *Int. J. Middle East Stud.* 14(1). 6.

¹⁵ *ibid*

¹⁶ World Bank Group Global Report on Islamic Finance 2016; Islamic Finance; A Catalyst For Shared Prosperity at page 3. Accessible at <https://openknowledge.worldbank.org/handle/10986/25738?show=full> accessed on September 4, 2017.

¹⁷ Ernst and Young, World Islamic Banking Competitiveness Report 2016 at page 10. Available at [http://www.ey.com/Publication/vwLUAssets/ey-world-islamic-banking-competitiveness-report-2016/\\$FILE/ey-world-islamic-banking-competitiveness-report-2016.pdf](http://www.ey.com/Publication/vwLUAssets/ey-world-islamic-banking-competitiveness-report-2016/$FILE/ey-world-islamic-banking-competitiveness-report-2016.pdf) accessed on September 4, 2017.

¹⁸ *Ibid*

¹⁹ World Bank Group Global Report Op cit (n16)

²⁰ Under this system, instead of charging a fixed rate of interest on its lending, the bank enters into an equity-sharing relationship with the client and shares in the risk and return, as well as profit and loss of a joint venture. M. Khan M Bhatti, '*Developments in Islamic Banking; case of the Pakistani*' at page 81.

²¹ *Ibid*.

the amendment, the then Financial Institutions Act, 2004, had restrictions rendered the operation of Islamic banking practices in the country impractical.

First, section 37 of the Act barred banks from engaging in trade, commerce and industry. This prohibition subsequently handicapped the smooth operation of Islamic banking since Islamic finance significantly thrives on financial institutions' engagement in these particular sectors as shall be seen later on in this paper.²² Further section 38 of the same Act prohibited banks from acquiring immovable property which was otherwise not meant for conducting financial institution business. This resultantly crippled Islamic banking since in some Islamic finance contracts, a bank must purchase and own an asset before it can resale the same to a client/customer at a profit.²³

However, the lucrative nature of the concept has attracted the Ugandan government (a predominantly Christian state²⁴, though secular²⁵) to jump on to this Islamic finance wagon in an attempt to harness the said opportunities it presents.²⁶ The FIA 2004 was subsequently amended to lift the aforementioned restrictions so as to allow Islamic banking flourish.

This importance of Islamic banking is reiterated by the governor of the Bank of Uganda²⁷ who posits that Islamic banking model where each contract is backed by an underlying asset or investment activity leads to a direct link between financial markets and economic activity. This contributes to the spread of real-asset-based finance principles and is ideal for financing infrastructure projects.²⁸ This is known as the debt financing model however there

²² Emmanuel Tumusiime Mutebile; 'Islamic Banking in emerging markets- forging Uganda's economic progress; Keynote speech by the Governor Bank of Uganda at the Islamic Banking Conference Kampala', on the 13th of May 2016. <http://www.bis.org/review/r160519f.pdf>

²³ This tenet of Islamic finance is known as *Murabaha* (cost plus sale). This concept according to Hans Visser, is a contract that requires the financier to sign two different contracts, one with the supplier of the commodities and another with the client to whom the financier will in turn sell to at a profit. 'Islamic Finance: Principles and Practice, 2nd Edition' at page 68.

²⁴ According to the 2014 census, over 84 percent of the Ugandan population profess Christian while about 14 percent of the population adhered to Islam.

²⁵ Article 7 of The Constitution of the Republic of Uganda 1995.

²⁶ The Executive Director Supervision, Bank of Uganda (BoU), Ms Justine Bagyenda during an interview with a national daily said one of the reasons for Uganda adopting Islamic banking was due to its exponential growth and resilience to financial crises. Ismail Musa Ladu, 'Islamic banking cleared for business, says regulator'. *The Daily Monitor* available at <http://www.monitor.co.ug/Business/Islamic-banking-cleared-business-regulator/688322-3204576-14o1789z/index.html> accessed on September 4, 2017.

²⁷ Emmanuel Tumusiime Mutebile op cit (n22).

²⁸ *ibid*.

is also, the *risk-sharing* characteristic of Islamic banking. Herein, the borrower and the bank share the risk of any investment on agreed terms, and share any profits or losses between them, without recourse to guarantees.²⁹ This therefore encourages lending especially to clients who may not have property.

However this thesis through critique of Islamic finance also questions whether this type of banking is without pitfalls. There are existing schools of thought that are opposed to Islamic banking such as those that argue that the Islamic concept of replacing of interest with profit and loss sharing is not feasible. Timur Kuran for example argues that the *Murabaha* mode of finance requirement for payment of time-value for money is equivalent to an interest-based conventional bank loan.³⁰ This mode requires that a trader submits a list of requirements he wants to purchase to the Islamic bank which then buys the goods.³¹ The bank then sets a markup price as its compensation for the service rendered and upon payment the bank transfers ownership to the client.³² The bank however sends the client a bill at an inflated price because of the risk it bears from the time it purchases the consignment to the time transfer is made because it does indeed bear the risk during this time and would pay in case of damage.³³ However in practice, this period of risk is negligible because there is no minimum to the duration of the bank's ownership; a millisecond suffices to make the transaction legitimate.³⁴ The bank has no risk, and the client pays for the time-value of money.³⁵ The only difference is in form and not in substance, which is that the client's payment is called a "markup" in Islamic banking and "interest" in conventional banking.³⁶

²⁹ M. Khan M Bhatti, 'Developments in Islamic Banking; case of the Pakistani' at page 81

³⁰ Timur Kuran, *Islam and Mammon; The Economic Predicaments of Islam* (Princeton University Press).

³¹ *ibid.*

³² *ibid.*

³³ *ibid.*

³⁴ *ibid.*

³⁵ *ibid.*

³⁶ Timur Kuran also argues in *The Financial Times* article, 'Islamic finance sits awkwardly in a modern business school' that "Islamic banks give and take interest as a matter of course, though under the guise of commissions, fees, penalties or profit shares. The holder of a "halal" credit card pays a penalty on unpaid balances; this penalty is proportionate to the size of the balance, which makes it equivalent to interest". He further posits that the *shari'ah* code was suited to the Middle Ages, when it assumed its classical form and that at least on matters of economics and finance, it has not advanced measurably since then. See <https://www.ft.com/content/ee2a2b36-9de5-11e2-9ccc-00144feabdc0#axzz3Qlujrt5w> (accessed on August 12, 2017).

Further, the Islamic banking concept of '*haram*' is not without criticism. This dictates that investment in certain industries such as adult entertainment, narcotics, tobacco, alcohol, and gambling is in contravention with *Shari'ah* law.³⁷ It is the author's submission that this prohibition of investment in certain products may bring about loss of profit opportunities in global free trade market. This is especially in respect to the alcohol industry where Uganda has been ranked as the world's leading consumer of alcohol per capita.³⁸ This market is clearly profitable in Uganda and the prohibition of investment in it is counterintuitive and does not make much economic logic for a sector vying to be a finance powerhouse.

The regulatory and supervisory aspects of Islamic finance further present a challenge. Legal complexity from this respect is derived from the nexus between the existing conventional banking legal jurisprudence and Islamic law. Reliance on Islamic principles leads the sector to operate in an '*unorthodox*' manner distinguishable from its conventional counterparts since the former unlike the latter does not deny existence of a link between its modus operandi and religion.³⁹ After deliberating on the Ugandan banking sector's genesis and the various concepts of Islamic banking, this paper will conduct a compatibility assessment between Islam and banking. It is this thesis' position that this dual alliance should be a synergy working towards the same goal of economic advancement and inclusive growth. This can only be attained through a legislative and supervisory equilibrium between the two as opposed to a conflicting dichotomy.

Similarly, being an emerging industry in Uganda, bank regulators should not haphazardly rush to the collect benefits of this Islamic finance without setting up a strong legal and institutional frameworks designed to deal with the bank. There should massive sensitization and training about the models of Islamic banking. There are lessons which can be learned from Malaysia which was ranked as a leading Islamic Finance country and one of the top nine core markets for world Islamic banking by The Ernst and Young World Islamic

³⁷ Quran 7:33

³⁸ World Health Organization Global Status Report on Alcohol 2007.

³⁹ Iqbal, Zamir, and Abbas Mirakhor. 'An introduction to Islamic finance: theory and practice'. Vol. 687. John Wiley & Sons, 2011.

Banking Competitiveness Report 2016.⁴⁰ Malaysia has specific legislation that deals with Islamic banking whereas Uganda amended the existing Financial Institutions Act to cater for Islamic banking. This may result into a collision within the dual banking structure that is conventional and Islamic banking, during their operations since they lay on the same field.

Pursuant to the Malaysian example, the thesis will propose amendment of tax laws to avoid double taxation challenges faced by Islamic finance, that there is need for separate structures at some point such as Islamic finance tribunals that would have the expertise to specifically handle Islamic banking disputes of a technical manner that a conventional court may not effectively handle.

1.2 Research Aims and Objectives

The objectives of this paper are threefold as follows:

- 1.2.1 The first stage is to determine whether or not this new concept of Islamic banking is healthy or detrimental to the stakeholders namely, banks, clients and the economy at large. Does it close the gap between rich and poor and encourage inclusive growth.

This paper analyses whether the introduction of Islamic finance by the Financial Institutions (Amendment) Act 2016 is the much needed panacea to help alleviate the obstacles to economic development and financial inclusion. In as much as Islamic finance's impact on Uganda's economy is likely to be exponentially productive, is it possible that it can be detrimental to a largely agrarian third world country's economy like Uganda. Is there any opportunity cost or detriment likely to be suffered because of the introduction of this type of finance? Are the banks themselves likely to make profits or losses

- 1.2.2 The second objective is to analyze the regulatory and supervisory structure of Islamic banking in Uganda under the Financial Institutions (Amendment) Act

⁴⁰ Report available at [http://www.ey.com/Publication/vwLUAssets/ey-world-islamic-banking-competitiveness-report-2016/\\$FILE/ey-world-islamic-banking-competitiveness-report-2016.pdf](http://www.ey.com/Publication/vwLUAssets/ey-world-islamic-banking-competitiveness-report-2016/$FILE/ey-world-islamic-banking-competitiveness-report-2016.pdf) Accessed on May 23, 2017.

and the third is to give recommendations in light of the lessons from Malaysia.

The thesis further sets out to review the new Financial (Amendment) Institutions Act in regard to Islamic banking. The growing presence of Islamic banking should be supplemented by effective regulation and supervision. So the questions to pose are; Whether the Act's regulatory measures are comprehensive to effectively operationalize Islamic banking in Uganda; whether there are any legislative and supervisory challenges which cannot effectively serve the purpose and meet the objectives for which the Act intended. Is Islamic banking properly supervised? Are there sufficient structures in conventional banks to support a dual system or should Islamic banking operate independent from the former.

And in the event that there are gaps, the recommendations the country can use to fill such lacunas using lessons from Malaysia.

1.3 Methodology

Primarily, the paper shall adopt the doctrinal approach through comparative analysis of relevant legislation of countries with Islamic finance with more emphasis on Uganda and Malaysia so as to best position subsequent recommendations. Reference shall also be, made to case law.

This thesis will also use the narrative methodology in reviewing the literature. This is because since the narrative literature review surveys the state of knowledge on a particular topic and yet there is scarcely any written paper concerning this study in Uganda. Therefore, the literature reviewed ranges from papers in Google scholars, web pages, newspaper articles and government documents. The intention is to recommend a standardized regulatory framework for Uganda and other low development countries with Islamic banking.

The thesis shall also rely on secondary sources such as journals and articles published by the Bank of Uganda, Ministry of Finance, Planning and Economic Development of Uganda, the Central Bank of Malaysia (Bank Negara Malaysia), The

Ministry of Finance of Malaysia, as well as international financial institutions such as The World Bank and The International Monetary Fund and other authorities from other jurisdictions where Islamic banking has been prevailing.

In order to fully comprehend the likely impact of Islamic banking in Uganda, historical research about the evolution of the banking sector in the country will also play an important role in the study. Materials such as Budget speeches, Ministerial instruments, cabinet white papers, draft legislation, press releases, news articles, previous legislation and older case law will be referred to in order to outline the deeper nuances of contextual and historical perspective of the subject matter at hand, and the changes proposed in the current legislation.

1.4 Overview of Chapters

Chapter two recapitulates the history of banking in Uganda to show the trek the country's banking sector has taken. It also covers the economic and financial inclusion status of the country mostly to assist elucidate the degree of impact that Islamic banking is likely to have on Uganda as discussed in the section that follows next. To give a contextual background into the economic challenges the country faces as of today,

Chapter three explains what Islamic banking entails, the principles of Islamic finance. The rules and regulations that govern the concept according to the Quran. The evolution of Islamic finance and its current status on the international scene in the wake of globalization. Since Islamic banking has been a new concept in Uganda's financial sector, for hardly a year in existence, this part of the thesis will mainly through thorough comparative analysis of other successful jurisdictions (*Islamic banking-wise*) project the likely impact of this type of banking in Uganda. The use of the current trajectory of the Islamic banking trend in Uganda shall also be heavily relied on in deducing the probable impact. Overall, this chapter answers the question, whether Islamic banking is beneficial in solving the challenges hindering financial inclusion and economic development at large.

Chapter four assesses whether the Financial Institutions (Amendment) Act 2016, being the main legislative basis of Islamic banking in Uganda, sufficiently addresses all issues related to Islamic finance. Whether it actually will bring about the results it sets out to

achieve. It also addresses and analyses the supervisory powers and discretion of the Central Bank of Uganda over Islamic banks. It is the position of the author that the existing laws are not favorable to the proper functioning of the Islamic banking. Therefore this section aims to identify the major regulatory challenges faced by Islamic banking in Uganda and provide subsequent recommendations in the next chapter to iron out the quoted issues.

Chapter five is primarily comparative analysis based on Islamic finance in Malaysia which has successfully practiced Islamic banking since 1963 and as such would be an appropriate model for an infant Ugandan Islamic banking sector to learn from. They have more comprehensive regulatory legislative and technical supervisory bodies, all of which can inform my recommendations to the Ugandan scenario. The Ernst and Young World Islamic Banking Competitiveness Report 2016 ranks Malaysia as a leading Islamic Finance country and one of the top nine core markets for world Islamic banking; therefore if Uganda is to become a force to be reckoned with at the Islamic finance global stage, Malaysia would be an ideal economy to pick a leaf from.

CHAPTER TWO

2. THE EVOLUTION OF FINANCIAL INSTITUTIONS IN UGANDA AND THE STATUS OF THE ECONOMY AND FINANCIAL INCLUSION.

2.1 Background and Evolution Of The Banking Sector In Uganda

2.1.1 Pre-Independence Era

The first financial institution in Uganda was established in November 1906 and it was the National Bank of India.⁴¹ Six years later, the second bank, Standard Bank of South Africa Limited was established in September 1912 followed by Barclays bank in 1927.⁴² In 1954 three more banks; Bank of India, Bank of Baroda and The Nedelandsche Handel-Maatschappij M.V opened in Uganda.⁴³ The Lombank Uganda Limited opened in 1958 and introduced the hire purchase system of shopping in Uganda.⁴⁴

The banking system at that time in Uganda did not control much of the financial liquidity that was in circulation across the board in the country.⁴⁵ Saben states that *'Much of the money was controlled in the bazaars and other channels which were predominantly controlled by people of the Asian origin...However, areas where banks were non-existent, merchants in those areas played the part of the banks'*.⁴⁶

Other alternative sources of accessing credit at the time were from regular moneylenders and through domestic lending, that is, people borrowing from family members or friends for short terms and without interest.⁴⁷ Even the few moneylenders' activities that existed were frustrated by a legislation passed by the Uganda Protectorate government in 1951.⁴⁸ This Ordinance provided, *inter alia*, that money lending agreements should be in writing, all money lenders should be licensed, interest rates were capped at 23 per cent and no special

⁴¹ Later taken up to become Grindlys Bank and played the role of banker to the Government till the Bank of Uganda was established.

⁴² Henry Lubega, 'The First Bank In Uganda' *Daily Monitor* March 1, 2016. Available at <http://www.monitor.co.ug/News/Insight/The-first-bank-in-Uganda/688338-2638762-tje191z/index.html> accessed on May 21, 2017.

⁴³ *ibid.*

⁴⁴ *ibid.*

⁴⁵ HBT. "Saben's Commercial Directory and Handbook of Uganda, 1947-48." (1948): 100-100.

⁴⁶ *ibid.*

⁴⁷ Department of Cooperative Development Annual Report 1948 at Page 5.

⁴⁸ Ordinance number 31 of 1951.

protection was afforded to African borrowers.⁴⁹ This placed stringent measures on would be lenders and deterred people from seeking loans since there were high interest rates.⁵⁰ Moreover at that time, not many Ugandans had received a formal education to be able to draft or read the legally required agreements need before engaging in a money lending transaction. Consequently money lending in Uganda was practiced on a small scale and mainly by the Asian community.⁵¹

Further, during the colonial times leading up to independence in October 1962, Ugandans did not hold substantive securities to obtain credit from the commercial banks.⁵² This is because they were mainly vested in subsistence agriculture and little output was left for commercial purposes.⁵³ Subsistence farming accounted for just over 50 percent of African agricultural products in 1950.⁵⁴

The agricultural practice by most communities was on a fragmented basis and small scale which led to low productivity.⁵⁵ The prevailing land tenure system⁵⁶ that vested most of the Ugandan land to the British imperialists and individual traditional rulers meant that most people had no land to use as collateral security for loans from the banks.⁵⁷ Besides the banks were reluctant to issue loans to a subsistence farmer likely to fail in meeting their repayment obligations timely or ever.⁵⁸

In 1950, cognizant of this barrier to credit access, the colonial government passed the Uganda Credit and Savings Bank Act⁵⁹ that established the Uganda Credit and Savings Bank. Its mandate was to provide credit to Africans with the objective of furthering agriculture, commercial building and cooperative society purposes in the protectorate.⁶⁰ In 1950, it issued 830 application forms between 2nd October and 31st December and in

⁴⁹ Saben's *op cit* (n 45).

⁵⁰ *ibid.*

⁵¹ Loxley, John. *The development of the monetary and financial system of the East African currency area 1950 to 1964*. PhD Diss. University of Leeds, 1966. P.108 1966.

⁵² Uganda Credit and Savings Bank Annual Report 1962/63, p.2

⁵³ Diana M. Hunt, *'Agricultural Credit in Uganda' University of East Africa, 1967.*

⁵⁴ Uganda Government Statistical Abstract 1957, P.79.

⁵⁵ *ibid.*

⁵⁶ *ibid.*

⁵⁷ Diana M. Hunt *op cit* (n53).

⁵⁸ Loxley, John *op cit* (n51).

⁵⁹ Under Ordinance number 20 of 1950.

⁶⁰ Saben *op cit* (n 45).

response, 298 members of the general public submitted forms to the bank requesting for loans worth Uganda Shillings (UGX) 4,533,900/=. Of these, only 166 worth UGX 829,300/= were approved.⁶¹

2.1.2. Post-Independence Era; A Nascent Banking Sector

In 1966 the Bank of Uganda (BOU) was established as the nation's Central Bank.⁶² The BoU under the Act had powers to control credit of banks and determine rates of interest commercial banks were to follow.⁶³ As of contemporary times under the amended Bank of Uganda Act 1993⁶⁴, the BOU is a body corporate with perpetual succession and a common seal and may sue or be sued in its corporate name.⁶⁵ Section 4 of the BOU Act stipulates the functions of the bank. It provides that, "without prejudice to the generality of subsection (1), the bank is mandated with maintaining monetary stability;⁶⁶ maintaining an external assets reserve;⁶⁷ issuing currency notes and coins;⁶⁸ being the banker to the Government;⁶⁹ acting as financial adviser to the Government and manager of public debt;⁷⁰ advising the Government on monetary policy as is provided under section 32(3) of the BOU Act;⁷¹ where appropriate, act as agent in financial matters for the Government;⁷² be the banker to financial institutions;⁷³ be the clearing house for cheques and other financial instruments for financial institutions;⁷⁴ supervise, regulate, control and discipline all

⁶¹ Uganda Credit and Savings Bank, Annual Report, 1950, P.2.

⁶² Established under Bank of Uganda Act 1966 which now operationalizes Article 161 of the Constitution of the Republic of Uganda, 1995 (as amended).

⁶³ section 2.

⁶⁴ Chapter 51.

⁶⁵ Section 2(2) of the BoU Act, Cap. 51. In terms of subsection 3, BoU may, subject to the limitations contained in the Act relating to the business which the bank may carry on, purchase, hold, manage and dispose of real and movable property, and may enter into contracts that may be expedient.

⁶⁶ Section 4(2)(a).

⁶⁷ Section 4(2)(b).

⁶⁸ Section 4(2)(c).

⁶⁹ Section 4(2)(d).

⁷⁰ Section 4(2)(e).

⁷¹ Section 4(2)(f)

⁷² Section 4(2)(g)

⁷³ Section 4(2)(h)

⁷⁴ Section 4(2)(i)

financial institutions and pension funds institutions;⁷⁵ and where appropriate, participate in the economic growth and development programs.”⁷⁶

The following era was characterized by misguided financial policies⁷⁷ and intermittent wars by the turbulent political regime led by President Idi Amin (1972-1979) which grossly affected the banking sector. Out of the 290 commercial bank branches existent in Uganda in 1970, only 84 existed by the end of 1987, of which 58 branches were operated by government-owned banks.⁷⁸ This drop is mainly attributed to the fact that Idi Amin expelled foreigners mainly Asians⁷⁹ and British subjects of Asian descent from Uganda.⁸⁰ This created a harsh economic environment for foreign investors and likely deterred would be bankers from venturing into the sector.⁸¹ The already established foreign banks, for fear of being persecuted by the government,⁸² had to reduce further investment into the sector because of the looming uncertainty over their heads and this inadvertently and subsequently led to a reduction in bank activities in the nation.⁸³ The expulsion of the foreigners subsequently led to the expansion of government owned Uganda Commercial Bank and Cooperative Bank as the foreign owned businesses were nationalized and assimilated by public ones.⁸⁴

⁷⁵ section 4(2)(j)

⁷⁶ section 4(2)(k)

⁷⁷ The economy was suffocated by extensive administrative controls over imports, foreign exchange, financial markets, and prices of commodities all of which subsequently led to acute distortions and contraction of the formal and monetized economy.

⁷⁸ The History of Banks Uganda Bankers' Association. <http://ugandabankers.org/history-of-banks/> accessed on May 19th, 2017.

⁷⁹ In Uganda at the time of the expulsion, there were approximately 80,000 individuals of South Asian descent and 23,000 of them had had their applications for citizenship both processed and accepted. “1972; Asians given 90 days to leave Uganda” British Broadcasting Council, 7th August 1972. Available at http://news.bbc.co.uk/onthisday/hi/dates/stories/august/7/newsid_2492000/2492333.stm accessed on May 19, 2017.

⁸⁰ Martin Brownbridge, Financial Repression and Financial Reform in Uganda 1994. Available at <https://www.ids.ac.uk/files/Wp30.pdf> accessed on May 16, 2017.

Brownbridge further opined that reforming financial markets to revitalize the banking sector in Uganda would be arduous venture because the institutional fabric of the sector was grievously damaged during the 1970's and 1980's by the government's imprudent fiscal policies and implications of civil war and unrest that led to financial repression.

⁸¹ *ibid.*

⁸² Idi Amin had alluded to foreigners as “*bloodsuckers*” and accused them of milking the Ugandan economy of its wealth. M.Brownbridge op cit (n 80).

⁸³ *ibid.*

⁸⁴ The History of Banks, op cit (n80)

2.1.3. A New Dawn: Bank And Economic Reform

With the advent of the National Resistance Movement (NRM) regime in 1986, security was restored to most of the country which invigorated the banking sector and economy at large.⁸⁵ Many of the administrative controls on the economy were subsequently liberalized and this saw the number of branches begin to increase gradually and a rise in banking activity signaled a resilient economic recuperation.⁸⁶ By 1990, the number of commercial bank branches had risen to 237, consequently increasing access by the populace to financial services provided by the banks.⁸⁷

In between late 1980's to mid-2000, the banking sector underwent several policy, legal and regulatory reforms. There was a renewed interest in the country by the International Monetary Fund and the World Bank. These gave technical and monetary assistance to restructure the Ugandan economy, mainly through Policy Framework Papers, which played a fundamental role in the economic reform of Uganda starting from 1988.⁸⁸ In 1987, the government with the support of both IMF and World Bank established the comprehensive Economic Recovery Program (ERP) with an aim to restore fiscal discipline, monetary stability, and price liberalization, attract foreign exchange inflows, improve the climate for private investment and savings, and rehabilitate the economy through bringing down the inflation rate and reducing the imbalances in the economy.⁸⁹

⁸⁵ Bategeka, Lawrence, and Luka Jovita Okumu. 'Banking Sector Liberalisation in Uganda: Process, Results and Policy Options.' *SOMO Centre for research on multinational corporations, Netherland* (2010).

⁸⁶ Ibid.

⁸⁷ Mukwanason, Hyuha, 1994, 'Interest rate policy and the saving-investment process in Uganda: a policy stance', *Uganda Institute of Bankers Journal*, 23

⁸⁸ See IMF, *Experimental IMF Report on Observance of Standards and Codes: Uganda*, Washington D.C. (1999).

⁸⁹ John K Baffoe, "Structural Adjustment and Agriculture in Uganda" International Labour Organization Working Paper –WP.149 available at http://nointervention.com/archive/Africa/Uganda/ilo_pub-index.htm last accessed on 18th May 18, 2017. Also see ;(World Bank, 1990, 1993; Kibirango and Kasekende, 1992; Bategeka, 1999).

2.1.4. Distress In The Banking Sector

Despite a promising and growing economy, the banking sector during the 1990's and 2000's found itself in an alarming distress situation. This period saw several local banks become insolvent while others were taken over by the BoU that would subsequently sell them off. This affliction was mainly attributed to poor corporate governance practice by these banks.⁹⁰ There was gross neglect of prudential regulation and supervision by the Bank of Uganda which led to internal mismanagement and skirting of basic corporate governance rules by both government and private banks.⁹¹ Regulation 3 of the Financial Institutions (Corporate Governance) Regulations, 2005 defines corporate governance within the context of financial institutions as the process and structure used to direct and manage the business and affairs of a financial institution with the objective of ensuring its safety and soundness and enhancing shareholder value.⁹² At the core of proper corporate governance is an inference that the insiders who control the management of a firm do not abuse their control and act in a manner deleterious to the interests of outsiders.⁹³ This was not the case as in many of these failed banks, a dominant shareholder would use their position to unduly influence bank management which subsequently led to abuses such as pervasive insider lending. According to Governor Emmanuel-Mutebile, the losses incurred on insider loans were the primary cause to the collapse of these banks.⁹⁴ In many of the failed banks, a dominant shareholder or group of shareholders would exert undue influence over the management, which would result in abuses such as pervasive insider lending.⁹⁵ The losses

⁹⁰ According to Governor Emmanuel Tumusiime-Mutebile during his address to the Kenya Commercial Bank (KCB) Board of Directors Retreat held at Kampala on 2/11/2012 titled, "Corporate Governance and banking regulation in Uganda available at <http://www.bis.org/review/r121109d.pdf> accessed on May 22, 2017.

⁹¹ "Poor and abusive management flourished because boards of directors were usually weak, lacking the professional expertise, values and competence; and often wanting in terms of independence to provide any effective oversight required for prudent bank management". Ibid.

⁹² Corporate governance in banking is unique from that in non-financial firms. This is because of the peculiar nature of banks in as much as they are heavily leveraged and that a substantial amount of their liabilities is owed to a substantial number of atomized depositors who bear a higher risk as they have the most to lose from abusive or negligent management. Subsequently, a priority objective of corporate governance in banking is the protection of the interests of depositors. Further, the corporate governance of banks attaches critical importance to the veracity and reliability of financial information.

⁹³ A. C. Fernando, *'Corporate Governance: Principles, Policies and Practices'* Pearson Education. at page 14.

⁹⁴ Governor Emmanuel Tumusiime op cit (n90)

⁹⁵ ibid

incurred on bad insider loans were the single most leading cause of bank collapse.⁹⁶ In diagnosing the high rate of failure by banks, Brownbridge,⁹⁷ observes that some of the closed banks were in distress because they were ponderously insolvent and put under liquidation with minimal delay.⁹⁸

In the aftermath of the 2008 global financial crisis, the BOU embarked on a number of reforms to reinforce the regulatory framework. Top of these was adopting the Basel III Liquidity Coverage Ratio in dealing with liquidity regulation. In November 2010, BOU directed commercial banks in to raise their minimum capital to UGX 10 billion (approximately US\$4.34 million)⁹⁹ by March 2011, and to UGX 25 billion (approximately US\$11 million) by March 2013.

The BOU further launched the development and implementation of a National Strategy for Financial Inclusion, under which financial consumer protection guidelines were issued to financial institutions in 2011.¹⁰⁰ In March 2011, the Central Bank also issued Consolidated Supervision Regulation to all banks¹⁰¹ which required all banks to report under these regulations as by 31st December of every year. These reforms have consequently improved the BOU's supervisory and regulatory potential as it now conducts on-site examination of all commercial banks using a risk-based supervision methodology and off site surveillance of these institutions. A recent BOU survey suggests that overall the sector is still sound with bank liquidity and capital buffers above the legal minimum.¹⁰²

⁹⁶ *ibid.*

⁹⁷ Martin Brownbridge is currently an economic advisor to Governor Mutebile.

⁹⁸ This is further evidenced in the case of *Robert Mwesigwa and Others v Bank of Uganda*, HCT-00-CC-CS-0588 of 2003 accessible at <http://old.ulii.org/ug/judgment/commercial-court/2005/33-0> .Accessed on May 23, 2017.

⁹⁹ (Official Exchange Rate in December 2010 was US\$1=UGX: 2,300).

¹⁰⁰ Whose objectives were to promote fair and equitable financial services practices by setting minimum standards for financial services providers in dealing with consumers.

¹⁰¹ This is in terms of the Financial Institutions (Consolidated Supervision), Regulations officially cited as Statutory Instrument No. 44 of 2010.

¹⁰² PWC Economic Outlook Report available at <https://www.pwc.com/ug/en/assets/pdf/economic-outlook-2017-first-edition.pdf> accessed on May 29, 2017.

2.2. Status Of The Economy And Financial Inclusion In Uganda

2.2.1. Gapping Inequality And Financial Exclusion

The banking sector is a central player in economic growth and inclusivity since it is a conduit through which finances are distributed.¹⁰³ The significance of financial inclusion cannot be understated. It is the author's submission that an inclusive, deep and widely accessible banking system goes a long way in promoting equal income levels and eradicating poverty. Such efficient intermediation motivates saving, facilitates access to credit for intending borrowers and reduces the cost of obtaining credit which subsequently lowers the gross transactional costs for enterprises making them attractive and competitive which is an aspect the nation is in dire need of.¹⁰⁴

According to *the Oxfam Uganda Inequality Report, 2017*, Uganda has alarmingly high rates of inequality with the richest 10 percent of the population enjoying 35.7 percent of national income while the poorest 10 percent claim only 2.5 percent and the poorest 20 percent have only 5.8 percent.¹⁰⁵ This goes to show the scathing levels of unfair distribution of finances to different segments of societies. Unsurprisingly the same report states that development has been skewed towards urban places mainly with less concern for the rural areas.¹⁰⁶ The incidence of poverty is significantly higher in rural localities at 22.8 percent of the population than in urban places which stands at 9.3 percent.¹⁰⁷ Poverty levels are also more prevalent in the North and Eastern parts of the country with the Western and Central divisions having lower incidences.¹⁰⁸

One the other hand, the status of financial inclusion in Uganda is sound, at least on paper. As a member of the Alliance for Financial Inclusion (AFI), the Bank of Uganda

¹⁰³Nombulelo Gumata, Eliphas Ndou argue that banking flows lead to sectoral credit reallocations in their text, 'Bank Credit Extension and Real Economic Activity in South Africa: The Impact of Capital Flow Dynamics, Bank Regulation and Selected Macro-Prudential Tools' *Palgrave Macmillan* p.137.

¹⁰⁴ According to Forbes Africa (May 2017 Edition), Uganda does not feature in the top 10 most competitive sub-Saharan African economies. Also see The Economic Forum Global Competitiveness Report (2016-2017) available http://www3.weforum.org/docs/GCR2016-2017/05FullReport/TheGlobalCompetitivenessReport2016-2017_FINAL.pdf accessed on May 30, 2017.

¹⁰⁵ 'Who is Growing? Ending Inequality in Uganda' Report available at https://www.oxfam.org/sites/www.oxfam.org/files/file_attachments/oxfam_in_uganda_inequality_report_compressed.pdf accessed on May 30, 2017.

¹⁰⁶ Ibid.

¹⁰⁷ Ibid

¹⁰⁸ Ibid

(BOU) signed the Maya Declaration wherein it committed to formulate financial inclusion strategies¹⁰⁹ and further under the Sasana Accord signed in 2013 in Kuala Lumpur, the BOU committed to reach a target of 70 percent overall financial inclusion in Uganda by 2017. BOU has since then, timely executed most of these committed policies¹¹⁰ and a FinScope Survey adopted by BOU suggests that Uganda has overachieved in this regard with overall financial inclusion rate of 85 percent which is way and above the targeted rate.¹¹¹ The BOU should be lauded for this achievement however, there remains a question of whether these statistics indeed reflect what is on ground. Rachel Mindra Katoroogo, a lecturer at Makerere University Business School, Department of Finance, disagrees.¹¹² She states that the numbers are far from reality after a locus visit to some rural parts. A greater segment of Ugandans, mostly poor, live in long forgotten rural areas in the North and Eastern part of the country. Even people in urban areas leaving in townships are badly off in terms of access to credit.¹¹³ Mindra asserts that *“the definition of financial inclusion does not simply mean access to financial services but most importantly availability, usage and quality of the formal financial system for all income segments of the economy both urban and rural alike with dignity.”*¹¹⁴ This assertion is valid since people may have bank accounts and operative mobile money profiles but this is irrelevant if there is no availability of finances. Further the numbers do not reflect the number of withdrawals, deposits or credit/debit card swipes on accounts per month and the frequency of mobile money

¹⁰⁹ The government formulated Vision 2040, as well as the Uganda National Development Plan 2010/11-2014/15 wherein there are commitments to improve financial inclusion based on four pillars namely; Financial Literacy, Financial Consumer Protection, Financial innovations and Improving Financial Services Data and Measurement.

¹¹⁰ The Alliance for Financial Inclusion 2016 Maya Declaration Progress Report, accessed at <http://www.afi-global.org/sites/default/files/publications/2016-08/2016%20Maya%20Progress%20Report-2.pdf> at page 58.

¹¹¹ FinScope National Survey Data for Uganda 2013 report accessible at https://www.bou.or.ug/bou/bou-downloads/Financial_Inclusion/Report-on-the-State-of-Financial-Inclusion-First-Edition-March-2014.pdf at page 6.

¹¹² Rachel Mindra Katoroogo ‘Maya Declaration; Reality v Uganda’s commitment’ *New Vision* Available at http://www.newvision.co.ug/new_vision/news/1418352/maya-declaration-reality-vs-uganda-commitment accessed on May 30, 2017.

¹¹³ In 2013, this was acknowledged by the Deputy BOU Governor Dr. Kasekende Louis while Launching the Uganda Rural Challenge Fund, an initiative to provide grants aimed at supporting innovations that can in turn improve access to finances for rural enterprises. He stated that *“...the disparity between urban and rural access to financial services is so wide with urban access at 48% compared to rural access at 35%. This would suggest that more than 12 million adults in rural areas do not have access to financial services. So definitely there is a lot of work to be done if the financial sector is to reach the more than 12 million rural adult population.”*

¹¹⁴ *ibid.*

transactions on average per month.¹¹⁵ So while there may be a significant number of people with accounts, this may not necessarily mean that they have access to credit.

2.2. Key Challenges Encountered By Government In Accelerating Shared Prosperity Through Financial Inclusion.

This part discusses some of the major challenges hindering financial inclusion and deepening in the country. The list may not be exhaustive but rather provides the gaps that the introduction of Islamic banking can help seal.

The high cost of accessing said credit in the first place is a major problem.¹¹⁶ Uganda ranks in the 120th position out of 138 states in affordability of financial services.¹¹⁷ This is mainly attributed to among others, high interest rates that usually range from 22 to 25 per cent of the principal sum borrowed.¹¹⁸ As of June 2016, commercial bank lending rates averaged 23.54 per cent and banks have been heavily criticized for their high lending rates to the private sector.¹¹⁹ Although as of April 2017, the BOU had reduced the Central Bank Rate (CBR) by 0.5 per cent points to 11 per cent,¹²⁰ this still remains a relatively high figure that will consequently likely force the conventional commercial banks to charge a higher interest rate to the public that wishes to obtain credit.¹²¹ It is no wonder Uganda's overall domestic credit to GDP ratio over the past ten years has scored at an abysmal average of 13 per cent.¹²² The World Bank reports that the population has shied away from banks mainly because of their increasingly stringent conditions for borrowing occasioned by

¹¹⁵ *ibid*

¹¹⁶ The World Bank, 'Uganda Economic Update Sheet' Published on February 8, 2017. Available at <http://www.worldbank.org/en/news/feature/2017/02/08/uganda-economic-update-fact-sheet> last accessed on June 6, 2017.

¹¹⁷ The Economic Forum Global Competitiveness Report (2016-2017) available at http://www3.weforum.org/docs/GCR2016-2017/05FullReport/TheGlobalCompetitivenessReport2016-2017_FINAL.pdf last accessed on May 30, 2017.

¹¹⁸ *Ibid*

¹¹⁹ Mark Keith Muhumuza 'Why Uganda's interest rates stubbornly remain high' *Daily Monitor newspaper* August 9, 2016. Available at <http://www.monitor.co.ug/Business/Prosper/Why-Uganda-s-interest-rates-stubbornly-remain-high/688616-3336400-102vbjsz/index.html> Accessed on June 6, 2017.

¹²⁰ Bank of Uganda Monetary Policy Statement for April 2017. Available at <https://www.bou.or.ug/bou/media/statements/Monetary-Policy-Statement-for-April-2017.html> Accessed on June 6, 2017.

¹²¹ The World Bank, *op cit* (n116).

¹²² *Ibid*

worsening quality of loans that had reduced private sector credit by 1.6 percent by September 2016.¹²³

This is partly why a recourse for saving the economy may lie with Islamic banking on this aspect. One main deterrent of loan application in conventional banking is interest taking which is prohibited in Islam.¹²⁴ Therefore, it is a reasonable assumption that people are likely to use this interest free banking alternative to circumvent the high interest rates and as such alleviate this problem.

Further, since the application of interest rate in transactions is prohibited, Islamic banks lend out money only on the basis of profit-sharing arrangements or other modes of financing permissible under Islamic law.¹²⁵ This could help source Uganda's ambitious infrastructure venture as will be further discussed in the next chapter. This venture has partly been the reason Uganda's public debt stands at 35 percent of the GDP.¹²⁶ It has risen by 12.7% in the past four years from 25.9% of GDP in 2012/13, to 38.6% of GDP in the 2016/17 financial year. Despite government's attempts to expand its financing base, Uganda's capital expenditures are still heavily dependent on external finance. Currently debt servicing accounts for 11 per cent of the total government expenditure making it one of the highest debt burdens in sub-Saharan Africa.¹²⁷ Uganda's GDP has averaged 4.5%, a pace notably lower than that of the East African Community members.¹²⁸

Secondly, apart from deterring new loan applications, high interest rates in Uganda have led to low repayments on loans by borrowers thereby inadvertently increasing the

¹²³ Ibid

¹²⁴ Stiglitz, Joseph E., and Andrew Weiss. 'Credit rationing in markets with imperfect information. *The American economic review* 71.3 (1981): 393-410.

¹²⁵ Khan, M.S. & Mirakhor, A. (1990). Islamic Banking: Experiences in the Islamic Republic of Iran. *Pakistan Economic Development and Cultural Change*, 38(2). 353-375. Retrieved from <http://www.jstor.org/stable/1154031>.

¹²⁶ Clara Mira, "IMF Sees Ugandan Growth Rebound in 2017-18 on infrastructure". Available at www.bloomberg.com/news/articles/2017-04-04/imf-sees-ugandan-growth-rebound-in-2017-18-on-infrastructure last accessed on May 29, 2017. The IMF states that debt levels for now remain manageable and at low risk of distress however this will change if they hit the 44% of GDP mark by 2021 as is anticipated.

¹²⁷ Bank of Uganda – State of the Economy Report: December 2016. This is projected to move to 16% of government's total expenditure by 2018. Uganda's debt burden has risen faster than the government's own resources consequently leading to a debt-to-revenue ratio of 236% according to PWC in its Economic Outlook Report available at <https://www.pwc.com/ug/en/assets/pdf/economic-outlook-2017-first-edition.pdf> last accessed on May 29, 2017.

¹²⁸ Economic Intelligence Unit – World's 20 fastest growing countries in 2017

number of Non-Performing Loans (NPLs hereinafter).¹²⁹ The IMF defines NPLs as “loans...when payments of interest and/or principal are past due by 90 days or more, or interest payments equal to 90 days or more have been capitalized, refinanced, or delayed by agreement, or payments are less than 90 days overdue, but there are other good reasons.”¹³⁰

The BOU Financial Stability Report for 2016 shows that there was an increase in NPLs from 4 percent of total loans in June 2015 to 8.3 percent in June 2016.¹³¹ The BOU however maintained that there was no cause for alarm since the NPL rates were still below the international standard for classifying NPLs as critical which stand at 10 percent.¹³² This has as of February 2017 risen to 10.5 percent, the highest in more than a decade.¹³³

It would seem the banking sector remembered nothing and forgot everything about the magnitude of the threat posed by NPLs which were the leading cause of its yesteryears’ financial distress.¹³⁴

Last year saw BOU take over the third largest bank in the country, Crane Bank Uganda Limited.¹³⁵ The Central bank stated that at the time of takeover, at least 20 percent of total loans in the bank were NPLs which partly led to its shut down.¹³⁶ Such Constant

¹²⁹ Martin Luther Oketch, ‘High Interest rates lead to rise in non performing loans’. *Daily Monitor Newspaper*. March 2009. During an interview with Dr. Charles Abuka, the BOU Financial Stability director, he indicated that because of the prevailing CBR at the time of 15%, the NPL ratio had increased by 1.2% from 4.1% to 5.3% in December 2015. Available at <http://www.monitor.co.ug/Business/High-interest-rates-lead-to-rise-in-non-performing-loans/688322-3108374-dfbawr/index.html> last accessed on June 6, 2017.

¹³⁰ Eighteenth Meeting of the IMF Committee on Balance of Payments Statistics Washington, D.C., June 27–July 1, 2005 presentation on ‘*The Treatment of Non Performing Loans*’. Available <https://www.imf.org/external/pubs/ft/bop/2005/05-29.pdf> last accessed on June 6, 2017.

¹³¹ Bank of Uganda op cit (n120).

¹³² According to Dr. Charles Abuka, the BOU Financial Stability director in an interview with Martin Luther Oketch of the Daily Monitor. Available at <http://www.monitor.co.ug/Business/High-interest-rates-lead-to-rise-in-non-performing-loans/688322-3108374-dfbawr/index.html> last accessed on June 6, 2017.

¹³³ Charles Mwaniki, ‘Non performing loans rates rises to 10.5’ *Daily Monitor Newspaper* published on February 20, 2017 available at <https://asokoinsight.com/news/non-performing-loans-rate-rises-to-10-5-uganda> accessed on June 6, 2017.

¹³⁴ Michael Brownbridge in his article “*Financial Repression and Financial Reform in Uganda*” at page 6 suggests that NPLs were a major cause for financial repression that took place during the 1970’s and early 1980’s.

¹³⁵ ‘*Bank of Uganda Takes Over Crane Bank*’ *Daily Monitor Newspaper* published on October 20, 2016. Available at <http://www.monitor.co.ug/News/National/Bank-of-Uganda-takes-over-Crane-Bank/688334-3423824-h675pvz/index.html> last accessed on June 6, 2017.

¹³⁶ *Daily Monitor Newspaper* article ‘*We are not exposed to Crane Bank toxic loans, says DFCU*’ published on February 2, 2017 available at <http://www.monitor.co.ug/Business/We-are-not-exposed-to-Crane-Bank-toxic-loans--says-dfcu/688322-3796052-104wx4q/index.html> last accessed on June 6, 2017.

distraught in the sector is likely to distort the economy and diminish public confidence in banks thereby discouraging the growth of a banked population.¹³⁷

Another cause of financial exclusion is the big informal sector. In Uganda, a significant amount of business is conducted informally. According to UBOS 2014, over 50 per cent of GDP is ascribed to the informal sector,¹³⁸ yet the World Bank estimates that only 1 in 10,000 entrepreneurs in Uganda is able to successfully obtain credit.¹³⁹ This is attributed to the fact that many of these informal businesses do not easily satisfy the requirements of the formal financial sector.¹⁴⁰ Banks require proper registration in order to open business bank accounts and disburse loans. Since registration fees are often prohibitively expensive for small business owners, and the processes for registration are cumbersome, they limit the use of such services by these businesses.¹⁴¹

As seen, this situation coupled with an ailing economy have contributed to lower consumer and investor confidence in the banking sector. As thus, a call for an immediate conspiring of the government and the private sector to save the situation is imminent.

Can interest free banking associated with Islamic Finance be the key to unlocking this plight of financial services affordability and poor loan quality? Can the Islamic banking resilience to global financial crises as well as the nature of Shari'ah-Compliant finance models that focus on the principles of investment in real assets and risk-sharing¹⁴² be the much needed breath of fresh air to re-ignite customer and investor confidence in Uganda's fiscal arena.

¹³⁷ The World Bank, op cit (n116).

¹³⁸ And 80 percent of the labor force work in the informal economy. See Andrew Rugasira 'Unpacking Uganda's Informal Sector' *The Independent*. May 22, 2016. Available at <https://www.independent.co.ug/unpacking-ugandas-informal-sector/> accessed on June 6, 2017.

¹³⁹ *ibid*.

¹⁴⁰ *ibid*.

¹⁴¹ Bemanya Tumwebaze, 'The bonus of formalizing your business' *The Daily Monitor* published on December 14, 2016. Available at <http://www.monitor.co.ug/Business/Prosper/The-bonus-of-formalising-your-business/688616-3485242-format-xhtml-81qcepz/index.html> last accessed on June 6, 2017.

¹⁴² Key Note Address by the Governor BoU, at the Islamic Banking Conference available at <https://www.bou.or.ug/bou/bou-downloads/speeches/GovernorsSpeeches/2016/May/ISLAMIC-BANKING-CONF-HOTEL-AFRICANA-13-MAY-2016.pdf> last accessed on July 13, 2017.

CHAPTER THREE

3. THE DEVELOPMENT OF ISLAMIC FINANCE AND ITS PROJECTED IMPACT ON INCLUSIVE ECONOMIC GROWTH IN UGANDA

3.1. Evolution of Islamic Banking

This section provides a brief genesis of the emergence and development of Islamic banking from the early era through the middle to modern times. As will be discussed later on in this paper, Islamic banking system is a financial system governed by *Shari'ah* law. This is religious law derived from precepts of Islam, particularly the *Quran* and the *Hadith* which are records narrating the words, actions or habits of the legendary Islamic Prophet Muhammad (Peace Be Upon Him) (herein PBUH).¹⁴³

The origin of Islamic banking can be traced back to the dawn of Islam 1,400 years ago. Historical scholars indicate that the early years of Islam show that during the first century of Islam (AD 600), there were some forms of Islamic finance that were similar to contemporary banking transactions such as Islamic partnerships (known as *Mudarabah* in modern Islamic finance).¹⁴⁴

The medieval era began with the end of the reign of Caliph Uthman in 661 A.C though banking activities which were practiced in the former era were continued.¹⁴⁵ With the fall of the Islamic empire occasioned by the rise of the Roman Empire, there were substantial consequences on the fiscal activities of Muslim nations.¹⁴⁶

Islamic finance revivalism however in response was first re-established in Mit Ghamr, Egypt 1963 with the Mit Ghamr Savings Bank.¹⁴⁷ This provided a basic financial institution bouquet which included deposits, loans, equity participation, direct investments and it relied on *Shari'ah* philosophy and was welcomed by the local populace.¹⁴⁸ With time,

¹⁴³ Hadith come second to the Quran in development of Islamic Jurisprudence. Ibn Hajar, Ahmad. Al-Nukat ala Kitab ibn al Salah, Vol 1. P.90. Maktabah al-Furqan.

¹⁴⁴ Ahmad Alharbi 'Development of the Islamic Banking System' *Journal of Islamic Banking and Finance* June 2015, Vol. 3, No. 1, pp. 12-25 available at http://jibfnet.com/journals/jibf/Vol_3_No_1_June_2015/2.pdf last accessed June 5 2017.

¹⁴⁵ *ibid.*

¹⁴⁶ *Ibid.*

¹⁴⁷ *ibid.*

¹⁴⁸ *ibid.*

the system spread over and by the 1970's many Islamic banks were thriving.¹⁴⁹ Some countries that were practicing Islamic finance came together under the auspices of the umbrella group, the Organization of Islamic countries (OIC) in 1974, and established a global bank called Islamic Development Bank (IDB).¹⁵⁰ Its objective was to engage in intergovernmental activities primarily to furnish funds for economic development of projects in member countries.¹⁵¹

3.1.1 Current Status Of Islamic Banking At The Global Stage

The global Islamic finance industry grew from US\$1.66 trillion in 2013 to US\$2.1 trillion in 2014.¹⁵² Consultancy firm PricewaterhouseCoopers has projected that this industry will grow to US\$2.7 trillion by end of 2017.¹⁵³ According to Ernst & Young, the Islamic retail and commercial banking assets continued to grow at 16% in 2014 and 2015 by 2020, the global Islamic banking industry profit pool is slated to peak at US\$30.3 billion.¹⁵⁴ Islamic banking assets in the six core markets of Qatar, Indonesia, Saudi Arabia Malaysia, United Arab Emirates and Turkey are projected to reach US\$1.8 trillion by 2019.¹⁵⁵

These success stories on the international scene can be replicated in Uganda's emerging markets if Islamic Banking principles are properly adhered to through proper regulation.

3.2. Principles Of Islamic Banking As Catalyst For Inclusive Economic Growth

The amendment in clause 1 (amending section 3 of the Financial Institutions Act) defines an Islamic financial institution as “*a company licensed to carry on financial*

¹⁴⁹ Ariff, M, (1982). Monetary Policy in an Interest-free Islamic Economy - Nature and Scope. In Ariff, M. (Ed.), *Monetary and Fiscal Economics of Islam*. International Centre for Research in Islamic Economics, Jeddah 1982.

¹⁵⁰ Per the Islam Development Bank website available at http://www.isdb.org/irj/portal/anonymous/idb_faq_ar

¹⁵¹ Its business structure included fees for financial services and profit sharing financial support for projects

¹⁵² PricewaterhouseCoopers, 'Islamic Finance: Creating Value,' available at https://www.pwc.com/ml/en/publications/islamic_finance_capability_statement.pdf (accessed on July 13, 2017)

¹⁵³ Ibid.

¹⁵⁴ Ernst & Young World Islamic Banking Competitiveness Report (2014 – 2015) available at <http://www.ey.com/EM/en/Industries/Financial-Services/Banking---Capital-Markets/EY-world-islamic-banking-competitiveness-report-2014-15> accessed on July 13, 2017.

¹⁵⁵ Ibid

institution business in Uganda whose entire business comprises Islamic financial business and which has declared to the Central Bank that its entire operations are and will be conducted in accordance with the Shari'ah." The FIA Amendment Act¹⁵⁶ then defines Islamic financial business as being financial institutions business which includes the business of receiving property into profit-sharing investment accounts or of managing such accounts any other business of a financial institution which is carried out *Shari'ah* and which includes (1) equity or partnership financing, including *musharakah*, *musharakah mutanaqisah* and *mudarabah*, (2) lease based financing, including *al-ijarah*, *alijarah muntahia bi al-tamlik* and *al-ijarah thumma al-bai*, (3) sale based financing, including *istisna'*, *bai' bithaman ajil*, *bai' salam*, *murabahah* and *musawamah*, (4) currency exchange contracts and (5) fee based activity, including *wakalah*.¹⁵⁷

This chapter defines key Islamic finance principles and what these *Shari'ah* compliant finance models are like and discusses whether they are the solution to Uganda's financial exclusion predicament.

3.2.1. Transactions Or Products Prohibited Under Islamic Finance

Haram

Shari'ah imposes a set of ethical rules militating against exploitation and investing in ventures that are considered morally distasteful.¹⁵⁸ As such investment in certain industries such as adult entertainment, narcotics, tobacco, alcohol, and terrorism is in contravention with *Shari'ah* law.¹⁵⁹

As submitted earlier, the prohibition of investment in certain products may bring about loss of profit opportunities found in some ventures such as the alcohol or pork businesses. For example Uganda is the second largest global consumer of pork¹⁶⁰ and

¹⁵⁶ Section 1(m)

¹⁵⁷ See also Craig Nethercott and David Eisenberg, 'Islamic Finance: Law and Practice' *Oxford University Press*, 2012.

¹⁵⁸ Mohamed Ariff, Munawar Iqbal, 'The Foundations of Islamic Banking: Theory, Practice and Education'. *Edward Elgar Publishers* at page 43

¹⁵⁹ Quran 7:33

¹⁶⁰ According to International Livestock Research Institute. See <http://www.monitor.co.ug/News/National/Ugandans-named-biggest-pork-consumers-Africa/688334-3479178-iffaagz/index.html> accessed on August 1, 2017.

biggest consumer of alcohol per capita in the world.¹⁶¹ Since Islamic finance prohibits trade in any of these two *sinful* ventures and more, then an opportunity to tap into this market is missed out and also the public that wishes to access credit engage in this business are forsaken. For instance, a study in Pakistan found that Islamic banks were comparatively underperforming on the basis of their business model and operational efficiency levels although they had better asset quality and superior stability position than conventional banks.¹⁶² This is because they always have comparatively less credit placement opportunities than conventional banks because of avoidance of investment avenues which are repugnant to Islamic principles.¹⁶³

Furthermore, the author submits that if absolute adherence to this principle was to be upheld, many other ventures that deal in products which are not acceptable to Muslims, even if their main business is *halal* (opposite of *haram*, that is, activities that are permitted by Islam) would be left out. Food retailers, hotels and airlines, for example, often derive a fraction of their profits from alcohol or pork food sales, but does this mean that such businesses are to be categorized with breweries and exempted from any Islamic investment portfolio?

However there are some illegal activities that are forbade which constructive inasmuch as it prevents the financing of some bad practices such as terrorism which destabilized the Ugandan economy in recent times.¹⁶⁴ Therefore prohibition in investment in such activities is good for the economy.

Speculation/Chance

This is also known as *gharar* – excessive risk-taking (for instance spread betting and hedge funds). *Gharar* is prohibited by Islam because of the ‘ignorance’ or ‘lack of

¹⁶¹ World Health Organization Global Status Report on Alcohol 2007

¹⁶² Aman, Ameenullah, Saqib Sharif, and Imtiaz Arif. "Comparison of islamic banks with conventional banks: Evidence from an emerging market." *Journal of Management Sciences* 3.1 (2016): 13-22.

¹⁶³ *ibid*

¹⁶⁴ Steven Candia, ‘Terrorism; A threat to regional economies’ The New Vision published on November 25th, 2013. Available at http://www.newvision.co.ug/new_vision/news/1334953/terrorism-threat-regional-economies accessed on August 1, 2017.

knowledge' and the broad risk of uncertainty.¹⁶⁵ Speculation is where two parties enter a contract and one party lacks complete information or both parties do not have control over the underlying transaction.¹⁶⁶ Whilst Islamic teaching encourages trading, investment and charitable giving, it prohibits the production of money by money since it requires financial transactions be asset-backed as will be seen further on in this thesis.¹⁶⁷ This creates a direct link between financial markets and economic activity thus contributing to the spread of real-asset-based finance principles.¹⁶⁸ This has been evidenced in many jurisdictions which consider it an ideal option for the financing of infrastructure projects.¹⁶⁹ This would provide Uganda with a conducive environment for achieving a more integrated approach to economic growth. This would further be a viable option for Uganda's government in its pursuit to develop infrastructure without having to resort to external debt.

It is imperative to differentiate the activities of speculators from those of legitimate investors. The later involves the rational use of knowledge, and the rewards come from having and knowing how to use information whereas speculative gains come from seeking out risk.¹⁷⁰ As explained in the next section of this chapter, with Islamic finance models such as the *Mudarbah*, there are rewards for risk sharing, but this activity of taking on the risk of others is different in nature from intentionally seeking risk.¹⁷¹

Speculation increases risk for all market participants by churning stock, or by engaging in destabilizing buying and selling. Yet it is impossible to prevent speculative investment in equity and bond markets through regulation.¹⁷² It is only the intent of the

¹⁶⁵ DLA Piper, 'Amendment to the Financial Institutions Act and The Concept of Islamic Finance In Uganda' available at http://www.sebalulule.co.ug/wp-content/uploads/2016/Sebalu_&_Lule_-_Commentary_on_Islamic_Finance_and_Amendments_to_the_FIA_-_12_February_2016.pdf Accessed on August 1, 2017.

¹⁶⁶ *ibid.*

¹⁶⁷ Rodney Wilson, (1997) "Islamic finance and ethical investment", *International Journal of Social Economics*, Vol. 24 Issue: 11, pp.1325-1342.

¹⁶⁸ Emmanuel Tumusiime Mutebile *op cit* (n22).

¹⁶⁹ *ibid.*

¹⁷⁰ Keon, N.S. (1989), *Stock Market Investment*, Berita Publishing, Kuala Lumpur, pp. 138-9. Nicholson, M. and Whittington, J. (1994), "Middle East: magic carpet not ready for take-off", *Financial Times Survey of Emerging Markets*, 7 February, p. 13

¹⁷¹ Rodney Wilson, *op cit* (n167)

¹⁷² Yusoff, N.Z. (1992), *An Islamic Perspective of the Stock Market*, Dian Darulnaim, Kuala Lumpur, 1992, pp. 89-93.

speculator, which becomes manifest latter on, which distinguishes speculation from genuine investment.¹⁷³ Hence conscience is the ultimate check. This implies that individual investors must honestly examine their motives and objectives for a certain venture and ensure that they are not in the business of mere speculation. This can benefit financial stability and constrain leverage.¹⁷⁴

Interest/Riba

As earlier pointed out, one of the key tenets of Islamic finance is that it prohibits interest-based transactions/instruments.¹⁷⁵ *Riba* (interest) means to increase, grow, or multiply into more than what would be due.¹⁷⁶ *Riba* prohibition is not exclusive restriction of interest only but also refers to the prohibition of undeserved profit gained from quantitative inequality of the counter value interest or usury that is reimbursing more than the principal advanced would then be one form of *riba*;¹⁷⁷ imposition of late fees would be an example of non interest *riba*.¹⁷⁸

The basis for this prohibition of *riba* on consumption loans is stemmed in the need to promote societal justice and equality by redistributing the purchasing power from the rich to the poor.¹⁷⁹ This is because it is assumed that those who borrow are seeking to maintain some minimum standard of living and as such to make a profit off them is against the spirit of charity.¹⁸⁰ However some Islamic finance scholars such as Timur Kuran have argued that those who insist on banning interest are ignorant of Islamic history and guilty of misinterpreting the *Quran* which he claims that it does not ban interest but rather prohibits usury or exorbitant interest.¹⁸¹ Nonetheless what the two schools of thought do not dispute is the forbidding of interest.

¹⁷³ Rodney Wilson, op cit (n167)

¹⁷⁴ DLA Piper, op cit (n165)

¹⁷⁵ “Those who charge *riba* are in the same position as those controlled by the devil’s influence...as for those who persist in *riba*, they incur hell, wherein they abide forever” –*Qur’an* 2; 275

¹⁷⁶ According to the Quran in Chapter 3 Verse 130, *riba* is defined as doubling and quadrupling the principal sum lent.

¹⁷⁷ Also see Ibrahim Warde, *Islamic Finance in the Global Economy* (Edinburgh University Press)

¹⁷⁸ *ibid.*

¹⁷⁹ Noorzoy, M.S. (1982, Feb). Islamic Laws on Riba (interest) and their Economic Implications. *Int. J. Middle East Stud.* 14(1). 6.

¹⁸⁰ *ibid.*

¹⁸¹ Timur Kuran, *Islam and Mammon; The Economic Predicaments of Islam* (Princeton University Press)

Riba/interest is ubiquitous in contemporary debt based economy. It is present in credit cards, automobile loans and home mortgages in the form of simple or compound interests.¹⁸² This subsequently raises two questions of critical importance. The first is about the practicality of an interest-free banking sector and secondly whether such is healthy for economic development and reducing the income inequality gap.

Interest free banking in Islamic finance is very practical because it is replaced by modes of lending which involve equity, sale or leasing through Profit-Loss Sharing (PLS) concept. This will be discussed in the next section but basically means a business partnership between the bank and the customer for the former to fund the latter's project and profits and losses are shared by both parties.¹⁸³

However purists disagree that at some point, there is an intersection with '*interest*'. They for example argue that then all investment in western markets and those of most Muslim countries is unacceptable, as quoted companies inevitably deal with *riba*-based banks.¹⁸⁴

Nonetheless, Islamic finance's direct avoidance of '*interest*' encourages relative economic stability and as such is healthy for the economy. This is because of its interest free system that is asset based in nature rather than interest based which is always fluctuating.¹⁸⁵ In Islamic banking, financing is based on real assets and therefore, Islamic products can only grow in step with the rise of real economy, thereby reducing excessive speculation and accelerating credit expansion.¹⁸⁶ A monetary system which is relying on interest free assets is proposed to have lesser element of uncertainty thus is more predictable and has reliable links to monetary policy objectives.¹⁸⁷ As such, Islamic finance would be a viable

¹⁸² Shafiel A Karim, *Islamic Moral Economy; A Study of Islamic Money and Financial Instruments* (Universal Publishers) at pg 23

¹⁸³ Craig Nethercott and David Eisenberg, *Islamic Finance: Law and Practice* (Oxford University Press, 2012). Also see Also see Ibrahim Warde *Islamic Finance in the Global Economy* (Edinburgh University Press) p45. Also see Kabir Hassan, Mervyn Lewis, "*Handbook of Islamic Banking*" (Edgar Elgar Publishing) at page 8.

¹⁸⁴ Rodney Wilson, op cit (n167)

¹⁸⁵ Uganda's Central Bank Rate has changed over three times in the first half of the year alone from 12 to 11 to 10 percent. See <https://www.bou.or.ug/bou/home.html> (accessed August 11, 2017)

¹⁸⁶ Daud Vicary Abdullah, Keon CheeI 'Islamic Finance; Understanding Its Principles And Practices' (*Marshall Cavendish Publishers*) at page 6

¹⁸⁷ Salinan H. Kassim, M. Shabri Abd. Majid and Rosylin Mohd Yusof, 'Impact of Monetary Policy Shocks on the Conventional and Islamic Banks in a Dual System; Evidence from Malaysia' *Journal of Economic Cooperation and Development* 2009 at page 41. Available at

alternative for Ugandans given that it is better suited to weather economic and financial crisis associated with interest rate fluctuations unlike conventional banking which is affiliated with such risks as seen in chapter two of this thesis.¹⁸⁸

It is further submitted that circumventing the payment of interest on loans would also help in the reduction of NPLs. This is because these fluctuating interest rates in Uganda have been a root cause for delayed or non-payment of loans as seen in chapter two above.¹⁸⁹ Since the NPLs are also among the causes of financial distress in the banking sector, an interest-free banking system would help avoid this scenario.¹⁹⁰ The logic of this claim is simple. Since NPLs have been a root cause for the resolution of banks in the country,¹⁹¹ a reduction in their rates would consequently solve the problem of banks shutting down which would then restore public confidence in the banking sector and subsequently increase the banked population thereby increasing financial inclusion.

However it should be noted that because of this nature, Islamic banks have extra liquidity challenges since they mainly deal in real property but nonetheless this situation benefits Islamic banks in terms of less Non-Performing Assets thus they have better asset quality.¹⁹² This would help Uganda reduce its already high prevalent rate of Non-Performing Assets that have threatened the sector and economy at large as seen in the above chapters.

The positive effects flowing from the interest-free Islamic finance on financial inclusion have been witnessed in some countries as reported by the World Bank. The Bank

https://www.researchgate.net/profile/M_Shabri_Abd_Majid/publication/254369532_Impact_of_Monetary_Policy_Shocks_on_the_Conventional_and_Islamic_Banks_in_a_Dual_Banking_System_Evidence_from_Malaysia/links/0a85e52e27cc1ba7a8000000.pdf last accessed on July 25, 2017.

¹⁸⁸ According to Governor BoU, Mutebile, Islamic Banking is attractive because of its resilience to financial crises. See <http://www.bis.org/review/r160519f.htm> last accessed July 26, 2017.

¹⁸⁹ Martin Luther Oketch 'High Interest rates lead to rise in non performing loans' *Daily Monitor Newspaper*, published on March 9, 2016. During an interview with Dr. Charles Abuka, the BOU Financial Stability director, he indicated that because of the prevailing CBR at the time of 15%, the NPL ratio had increased by 1.2% from 4.1% to 5.3% in December 2015. Available at <http://www.monitor.co.ug/Business/High-interest-rates-lead-to-rise-in-non-performing-loans/688322-3108374-dfbawr/index.html> last accessed on June 6, 2017.

¹⁹⁰ Ibid

¹⁹¹ According to the BoU, the root cause for resolving Crane Bank, the country's third biggest bank at the time, was that its Non-Performing Loans which had contributed to the bank's capital erosion that saw its capital fall below the 50% legal requirement. See <http://www.monitor.co.ug/News/National/Bank-of-Uganda-takes-over-Crane-Bank/688334-3423824-h675pvz/index.html> last accessed on July 26, 2017.

¹⁹² Aman, Ameenullah, Saqib Sharif, and Imtiaz Arif. "Comparison of islamic banks with conventional banks: Evidence from an emerging market." *Journal of Management Sciences* 3.1 (2016): 13-22

states that in OIC countries with Islamic Banking in 2014, 31 percent of the working age population had a bank account compared to the 17 percent in countries that did not have Islamic banking. Furthermore, between 2011 and 2014, the financial depth, measured as private sector credit to GDP stood at 39.5 percent of GDP in countries with Islamic finance compared to the 34 percent without Islamic banking.¹⁹³ Although not all success in this regard can be allotted to Islamic finance, it does nonetheless play a central role in increasing access to finance and creating financial depth which is critical for economic growth and development.

However, it is the author's submission that the prohibition of interest on money subsequently makes it difficult for devout Muslims to partake in the paying or receiving of interest. This makes it hard for them to use conventional bank products such as savings accounts, loans, mortgages and credit cards as well as discouraging foreign direct investments from the staunch Muslim would be investors. Therefore depending on one's perspective, Islamic finance can be considered detrimental to the economy since it discourages a section of the devout Muslim population from accessing credit through the use of products that come with interest.¹⁹⁴ This would subsequently reduce rate of financial inclusion.

Alternatively, one can look at Islamic finance as tool of accelerating financial inclusion; a complementary option to the conventional system. It was reported that a section of the Ugandan population especially Muslims had cited absence of Islamic banking that is in line with Islamic finance as sole reason for not having a bank account.¹⁹⁵ With the establishment of Islamic banking in Uganda, this will be done away with which will not only help boost financial inclusion but also attract Foreign Direct Investment from members of the Muslim Arab world. Also some of the transactions that caused the global financial crisis are forbidden by Islamic finance and this consequently encourages stability. Activities

¹⁹³ Keynote Speech by World Bank Group Senior Vice President Mahmoud Mohieldin, "Adapting to the New Macro Environment for Islamic Finance: Responding to Headwinds & Refreshing the Vision for Islamic Finance at the Islamic Banking and Investment" Asia/Middle East Congress, Singapore, April 5 2016. Available at <http://www.worldbank.org/en/news/speech/2016/04/05/speech-mahmoud-mohieldin-adapting-to-the-new-macro-environment-for-islamic-finance> last accessed on July 25, 2017.

¹⁹⁴ Julius Busingye, 'Islamic Banking Presents New Opportunities' *The Independent* available at <https://www.independent.co.ug/islamic-banking-presents-new-opportunities/> last accessed on July 27, 2017.

¹⁹⁵ Ibid

such as investing in or financing toxic assets, derivatives, and conventional financial institution securities all of which are prohibited by Islamic banking but were carried out by the conventional banks are said to have contributed to the crisis.¹⁹⁶

3.2.2. Islamic Finance Modes and Their Projected Implication on Uganda's Economy.

Profit and Loss Sharing

Suppose a bank lent ZAR 1000 to an entrepreneur seeking to kick start a project, at 5 percent interest for a period of one year; the bank would be entitled to exactly ZAR 1050 at the end of the year, since its return is predetermined. However the entrepreneur's return depends on the success of their project. That is, if their project's revenue exceeds ZAR 1050, they will make a profit. If it is below ZAR 1050, they will incur a loss.

As seen above, this is different from interest-based lending that vests the risk of loss entirely on the borrower (entrepreneur in this hypothetical) which under the interpretation of Islam is prohibited as sinful and unfair. So an alternative mode of funding is used in Islamic banking, ergo Profit and Loss Sharing.

Unlike conventional banking, Islamic financing is more of a trading activity than a financing one since it is mainly based on risk participation of all parties implying that two or more parties share not only the profits but also the risks of a joint venture.¹⁹⁷ It is for this reason that Islamic banking was initially impossible to operate by virtue of sections 37 and 38 of the then FIA, 2004 but these were repealed by the FIA Amendment Act 2016 to allow this finance based module operate.¹⁹⁸ This has made way for the emergence of the Islamic finance mode of PLS.

¹⁹⁶ Hasan, Maher Mohamad, and Jemma Dridi. "The effects of the global crisis on Islamic and conventional banks: A comparative study." (2010).

¹⁹⁷ Mervyn K Lewis, Mohamed Ariff, Shamsher Mohamad, 'Risk and Regulation of Islamic Banking' *Edward Elgar Publishing 2014* at page 107

¹⁹⁸ Section 37 prohibited Financial Institutions from directly or indirectly engaging in Trade, Commerce and Industry. This restriction inevitably hindered the smooth operation of Islamic Banking given that Islamic Banking is reliant on financial institutions' participation in these particular fields. Section 38 prohibited Financial Institutions from acquiring immovable property that was not intended for use in conducting banking business which basically constrained the operation of Islamic finance since in some Islamic Banking contracts, a Financial Institution must buy and therefore own the asset before reselling it to the customer at a profit.

Under PLS, an Islamic bank's lending operations are based on the same principle of risk sharing, that is, when the bank lends money to a firm, it agrees to share in the losses of the underwritten business activities in return for a share of any profits.¹⁹⁹ This resultantly, in comparison to interest based finance, is a fairer bargain to the parties and more so the debtor. This is because profit from business is uncertain whereas the excess amount the debtor pays accruing from interest is certain since it is predetermined as seen above. Therefore insistence on a sum certain in return for that which is uncertain is detrimental to the debtor.²⁰⁰

Mohammad Najatuallah Siddiqui, a leading Islamic finance pioneer proposed a two-tier model as the basis of an interest-free banking with *Mudarabah* (trustee finance) and *Musharaka* (equity participation).²⁰¹ These are further provided for under section 1(m) of the FIA 2016.

Mudaraba/ Partnership financing²⁰²

Under *Mudaraba*, an investor or silent partner (*rabbu-ul-mal*) entrusts capital to an entrepreneur (working partner or *mudarib*), who invests these funds, and then returns to the investor a pre-specified share of the resulting profits, along with their principal; the remaining share accrues to the entrepreneur as a remuneration for their time and labour.²⁰³ In the event of loss, the financial loss is entirely born by the investor, while the entrepreneur's loss is only but their spent labour efforts and time. This model inadvertently avoids the imposition of oppressively high interest rates on poor households and small entrepreneurs thereby reducing the head-costs of acquiring credit hence encouraging

The FIA 2004 was, therefore, amended to remove these said constraints for Islamic Banks and/or Conventional Banks that would want to offer Islamic Windows.

¹⁹⁹ Kuran, Timur. 'Islam and Mammon: The economic predicaments of Islamism'. *Princeton University Press*, 2004. This is also provided for by Section 1(m) of the FIA 2016 which in defining Islamic financial business provides that it is a business of receiving property into profit sharing investment accounts.

²⁰⁰ Mervyn K Lewis op cit 223

²⁰¹ Curtis, Mallet-Prevost, Colt & Mosle LLP (3 July 2012) "*Islamic Banking: A Brief Introduction*".

²⁰² Section 1(m)(b)(i) FIA 2016

²⁰³ Kuran, Timur. 'Islam and Mammon: The economic predicaments of Islamism'. *Princeton University Press*, 2004

inclusion.²⁰⁴ This is a good solution for Uganda since it is the high costs of credit access that mainly hinder the acceleration of financial inclusion as seen in chapter two.

Musharaka / Equity based finance²⁰⁵

With *Musharaka*, the entrepreneur makes a financial commitment to his project by supplementing with some of his own capital to that already supplied by the investor(s), exposing himself to a risk of capital loss.²⁰⁶

Therefore unlike conventional banks that base their loan disbursement decisions mainly on creditworthiness of its applicants,²⁰⁷ Islamic finance's PLS modules primarily focus on the potential profitability of the suggested business venture.²⁰⁸ This is good for Uganda's economy where only 1 in 10,000 entrepreneurs has access to credit.²⁰⁹ This is because although an applicant entrepreneur may not be creditworthy and with no property to use as collateral security, if their proposed project is economically promising they may succeed in securing a loan from an Islamic bank yet fail to secure a conventional bank loan for their project. This would promote deeper financial inclusion status in Uganda and ease access to credit and encourage productivity and real economic activity.

Furthermore, unlike their conventional counterparts, Islamic banks are involved in the implementation of the projects the entrepreneur underwrites, and at times they even supply managerial know-how.²¹⁰ Proponents of Islamic finance posit that this technique is highly similar to the venture capital industry which has fostered the rise of many new enterprises in many advanced economies and that Islamic banking can replicate those same results.²¹¹ This technical knowledge addition is likely to improve the project's success prospects and ensure returns than one where money is just disbursed without diligence done about the project's viability.

²⁰⁴ Ben Naceur, Sami, Adolfo Barajas, and Alexander Massara. "Can Islamic Banking Increase Financial Inclusion?" (2015).

²⁰⁵ Section 1(m)(b)(i) FIA 2016

²⁰⁶ Ibid

²⁰⁷ The FI Amendment Act 2016 also introduces the Credit Reference Bureaus concept under sections 26, 78A which make it mandatory for banks to conduct credit checks on all customers applying to them for credit.

²⁰⁸ Timur Kuran, *Islam and Mammon; The Economic Predicaments of Islam* (Princeton University Press) p15

²⁰⁹ Andrew Rugasira, op cit (n138)

²¹⁰ Kuran, Timur. 'Islam and Mammon: The economic predicaments of Islamism'. *Princeton University Press*, 2004

²¹¹ ibid

Therefore on that premise, there are high chances that Islamic banking can make an equally significant contribution to Uganda's economic development. A banking structure that pegs its loan disbursement decisions on project viability does not reject projects with excellent long-term prospects or would be entrepreneurs merely because of a bad financial track record. Consequently, it would seem to advance credit more efficiently than one that insists on demonstrated creditworthiness. The direct implication of this is rapid inclusive growth and benefit for all involved stakeholders: entrepreneurs, who find it easier to finance their projects; financial institutions, who share in the profits of the projects they underwrite; and depositors, whose investment accounts earn greater returns.

From the above, it is clear that both *Mudaraba* and *Musharaka* require particularly vigilant reporting and a high level of transparency for profits and losses to be distributed fairly. Consequently, given their complexity and repayment schedule and lack of proper accounting, they may result in substantial operating costs, particularly for micro and small enterprises that are not accustomed to formal accounting.²¹² This leads back to the high cost of accessing credit challenge and to avoid it, good corporate governance practices by the banks must be ensured by the *Shari'ah* advisory boards so as to encourage integrity and transparency that dispenses the need for hiring accountants by the clients.

Murabaha/ Sale based financing²¹³

Under this mode, a trader submits a list of goods they want to purchase to the bank. The bank then buys the goods and marks up its price as compensation for the service rendered upon which it then transfers the ownership to the client.²¹⁴ This exposes risk to the bank for that period before transfer. It is for this reason that the client then receives a bill at an inflated price to be paid at a date in the future.²¹⁵ Some scholars have criticized this as un-Islamic since the risk involved could be negligible, given that there is no minimum duration period of the bank's ownership; a minute suffices to make the transaction

²¹² El-Zoghbi, Mayada, and Michael Tarazi. "Trends in Sharia-Compliant Financial Inclusion." *Brief*. Washington, DC: CGAP (2013)

²¹³ Section 1(m)(b)(iii) FIA 2016

²¹⁴ Usmani, Taqi. *An Introduction to Islamic Finance*. Creative Commons Attribution-No Derivative Works 3.0. p. 65.

²¹⁵ Timur Kuran, *Islam and Mammon; The Economic Predicaments of Islam* (Princeton University Press) 2004

legitimate.²¹⁶ This makes *Murabaha* equivalent to an interest-based conventional banking loan: the bank bears no risk, and the client pays for the time-value of money and ultimately the only difference lies in semantics, which is that the client's payment is titled "service charge" or "markup" in one case and "interest" in the other. However Islamic banking under *Murabaha* does not involve penalties for late payment, while conventional banking requires it under interest and as such the former may be a less strenuous mode of credit access.²¹⁷ However for this model to be instrumental in deepening financial inclusion by reducing cost of obtaining credit, care must be made in the way banks and clients structure their arrangements. This is because managing the transfer of the assets results in operational costs that are often higher than disbursement of cash in conventional microfinance, costs that are likely passed on to the consumer.²¹⁸ This also has tax implications as will be seen in chapter four.

Another mode under this branch is known as the '*bai salam*' as stipulated under Section 1(m)(b)(iii) FIA 2016. This is a sale whereby the seller undertakes to supply some specific goods to the buyer at a future date in exchange for an advance price fully paid on spot.²¹⁹ The basic purpose of this sale contract is to meet the needs of the small farmers who need money to grow their crops and to feed their families up until the time of harvest.²²⁰ This is a critical tool for improving credit access to the 69 percent of the Ugandan population directly and indirectly involved in agriculture.²²¹ This would subsequently improve the agricultural sector which contributes to 26 percent of the nation's Gross Domestic Product.²²²

Ijara/ Lease finance²²³

This means a contract which enables possession of a particular intended usufruct of the leased asset for a consideration.²²⁴ The bank rents an asset to the client who is an end

²¹⁶ Ibid

²¹⁷ Ibid

²¹⁸ El-Zoghbi, Mayada, and Michael Tarazi. "Trends in Sharia-Compliant Financial Inclusion." *Brief. Washington, DC: CGAP* (2013).

²¹⁹ Kaleem, Ahmad, and Saima Ahmad. "Bankers' perception towards Bai Salam method for agriculture financing in Pakistan." *Journal of Financial Services Marketing* 15.3 (2010): 215-227.

²²⁰ Usmani, M.T.(1998) An Introduction to Islamic Finance. Karachi, Pakistan: Idaratul Ma'arif, p.186

²²¹ Deloitte, 'Uganda Economic Outlook 2016.; *The Story Behind the Numbers*' at page 10

²²² Ibid

²²³ Section 1(m)(b)(ii) FIA 2016

user for a specified duration of time at an agreed rental fee that reflects the assets' cost as well as time-value of money. The end user retains the option of buying the asset. This has the underlying concept of risk sharing since the bank owns the asset for some time and if it is damaged during the lease period, the resulting loss would be vested on the bank.²²⁵

This mode unlike *Mudaraba* and *Musharaka* has low costs of loan administration and monitoring because of its simple repayment schedule that allows for flexibility.²²⁶ This could be instrumental to helping farmers access credit in Uganda. For example, if a farmer is in need of initial physical capital like a tractor or any equipment, the Islamic financial institution can buy the equipment and lease them to the client.²²⁷ If the farmer however wishes to buy the equipment, the bank sells it to them at a markup price.²²⁸ The farmer (client) pays back the price in agreed upon installments in the future.²²⁹

From analyzing all these modes of Islamic finance, it is seen that the capital structure of Islamic banks as seen above comprises of substantial portion of equity participation with comparatively higher equity to asset ratio. This trait renders Islamic finance with a superior stability position than its conventional counterparts.²³⁰ The same reasons have been advanced for Islamic finance's resilience in the midst of the 2008 global financial crisis.²³¹ This would therefore be important for Uganda whose banking sector has been characterized by instabilities.

²²⁴ Ghuddah, Abdul Sattar Abu. 'Ijarah (lease).' *Dallah Al-Baraka Group Al-Baraka Banking Group (ABG) Department of Research & Development* (1998)

²²⁵ Timur Kuran, op cit (n30)

²²⁶ Hassan, Abul. 'Financial inclusion of the poor: from microcredit to Islamic micro financial services.' *Humanomics* 31.3 (2015): 354-371.

²²⁷ Iqbal, Zamir, and Abbas Mirakhor. 'Economic development and Islamic finance.' *World Bank Group*, 2013.

²²⁸ *ibid.*

²²⁹ *ibid.*

²³⁰ Ahmed, Habib. "Financial crisis, risks and lessons for Islamic finance." *ISRA International Journal of Islamic Finance* 1.1 (2009): 7-32.

²³¹ Chapra, M. Umer. 'The global financial crisis: can Islamic finance help?' *Islamic Economics and Finance*. Palgrave Macmillan UK, 2011. 135-142.

3.2.3. Islamic windows

Under section 115 A (1 to 3) of the FIA 2016, a financial institution carrying on business, may apply to the Central Bank to carry on Islamic financial business in addition to its existing licensed business through an Islamic window. This means the part of a financial institution, other than an Islamic financial institution, which conducts Islamic financial business.

This is beneficial to Islamic finance because Islamic banking services benefit/freeload from the structures and network that conventional banks have already established without having to start from scratch. This would subsequently improve the quality of services and lower their cost, which could improve intermediation between the two.²³² As seen in chapter 2, one of the key challenges faced by government in deepening financial inclusion is the high cost of accessing credit.²³³ Therefore the lowering of costs that come with the Islamic banking windows could help alleviate this challenge. Windows also do this by increasing competition in the market, which could reduce the cost of credit access for *Shar'iah*-compliant products.²³⁴

Further, Islamic banking windows facilitate liquidity management, especially in countries where Islamic liquidity instruments are finite.²³⁵ Windows usually have easy access to liquidity support from the conventional part of the bank. This could assist in stabilizing the banking sector which as seen in chapter 2 under challenges hindering financial inclusion, is growing concern.²³⁶ In addition for countries with small demand for Islamic banking services especially those with a low Muslim population, (like Uganda²³⁷) the window could be the only feasible way of providing Islamic Banking services, thus increasing financial inclusion.²³⁸

²³² Inwon Song and Carel Ousthuizen, “*Islamic Banking Regulation and Supervision; Survey results and challenges*,” IMF Working Paper 14/220 (Washington: International Monetary Fund 2014).

²³³ Uganda ranks in the 120th position out of 138 states in affordability of financial services. The Economic Forum Global Competitiveness Report (2016-2017)

²³⁴ Inwon Song, op cit (n232).

²³⁵ *ibid*.

²³⁶ The third biggest bank in Uganda, Crane Bank was according to the Central Bank shut down because it was under-capitalized and that had posed systemic risk to the banking sector. See Governor Bank Of Uganda Press release available at https://www.bou.or.ug/bou/bou-downloads/press_releases/2016/Oct/PRESS-RELEASE-Crane-Bank-Oct-20-2016.pdf last accessed on July 12, 2017.

²³⁷ According to the 2014 census, 14 percent of the population adhered to Islam.

²³⁸ Inwon Song, op cit (n232).

In conclusion, as discussed above, Islamic finance emphasizes trade in assets more than it does in financing consequently facilitating trade by assisting business people get the usufructs of assets which they could not have owned by themselves hence inducing a productive inclusive economy. Therefore, for this to work out properly there needs to be a well-founded regulatory and supervisory structure that not only heed to *Shar'iah* law of finance but also allows the banking sector to thrive.

CHAPTER FOUR

4. LEGISLATIVE FRAMEWORK AND CHALLENGES OF ISLAMIC BANKING IN UGANDA

4.1. Institutional Framework and Supervisory Bodies

The Bank of Uganda

The principle regulatory and supervisory organ in Uganda is the Bank of Uganda (BoU) which is the Central Bank.²³⁹ It is established under Bank of Uganda Act 1966 which now operationalizes Article 161 of the Constitution of the Republic of Uganda, 1995 (as amended). In general terms, the functions of BoU are to formulate and implement monetary policy directed to economic objectives of achieving and maintaining economic stability.²⁴⁰ Furthermore, BoU's functionality extends to development financing with a mandate of refinancing facilities to financial institutions; management of loans and grants for development projects through commercial banks; and closely supervising the outcome of the funds dispersed to commercial banks.²⁴¹

With the introduction of Islamic Finance concept, under the new FIA 2016, there is to be established a Central *Shari'ah* Advisory Council in the Bank of Uganda.²⁴² Its mandate is to advise the Central Bank on matters of regulations and supervision of Islamic banking systems in the country as well as approving any product to be offered by financial institutions conducting Islamic banking.²⁴³

Further, the legal framework of BoU also defines its interaction with financial institutions.²⁴⁴ In order to foster institutional harmony between the regulator and the banks, the BoU is given the mandate to cooperate with the financial institutions in order to promote and maintain adequate and reasonable banking services for the public; ensure high standards of conduct and management throughout the banking system; promote such policies not

²³⁹ Section 2(1) of the BoU Act, Cap. 51.

²⁴⁰ Section 4 of the BoU Act spells out the functions of the bank.

²⁴¹ Section 35 of the BoU Act provides that the bank shall not directly finance any development project with the exception of development funds established under section 29(6) of the same Act.

²⁴² Section 115B 2.

²⁴³ Section 115B 2 (a & b).

²⁴⁴ Under section 1(d) of the BoU Act, financial institution includes a bank, credit institution, building society and any institution classified as a financial institution by the central bank.

being inconsistent with any provision of the BoU Act; provide facilities for the clearing of financial instruments for financial institutions generally on terms determined by it.²⁴⁵

The Basel Committee on Banking Supervision (BCBS)

This is another supervisory authority Ugandan banks rely on. The BCBS sets guidelines for global regulation of banks. It is the media for agreeing international regulation on the conduct of banking which constitute an accord.²⁴⁶ The Basel Accord is a series of agreements set by the BCBS to provide guidelines and recommendations on banking regulation in order to minimize risks inherent within the financial sector.²⁴⁷ Although not a compulsory directive to nations, the BoU has occasionally adopted some of these guidelines as mandatory standards with which domestic banks must comply. In 2009, Uganda joined the Basel III framework with other countries expecting to build a banking sector that can withstand shocks that impacted the global banking system during the 2008 financial crisis.²⁴⁸ This was to be achieved through requiring banks to hold capital buffers of a minimum of UGX 25 billion and for bigger banks to even have more. This has been enforced by Uganda as seen in The Financial Institutions (Revision of Minimum Capital Requirements) Instrument No. 43 of 2010 in accordance with section 26(5) of the Financial Institutions Act 2004, revised the Minimum Capital Requirements of Commercial Banks. Further in line with the Basel III reforms, the BoU in December 2016 raised the minimum statutory capital adequacy ratios to 10 percent (up from 8 percent) of the risk-weighted assets of the bank on top of holding a capital conservation buffer of 2.5 percent of their risk-weighted assets.²⁴⁹

The Islamic Financial Services Board (IFSB)

This is an Islam specialized international standard-setting organization. It promotes stability of the Islamic banking sector by issuing international prudential standards and guiding principles for the sector, generally defined to include banking, capital markets and

²⁴⁵ Section 37 of the BoU Act.

²⁴⁶ *The Basel Committee on Banking Supervision: A History of the Early Years, 1974–1997.*

²⁴⁷ Rachanaa Datey & Kavita Tiwari ‘Basel III Norms and Indian Banks- A New Definition of Risk Management’ *International Journal of Advanced Research* (2014), Volume 2, Issue 7, at pg. 894.

²⁴⁸ See Mark Keith Muhumuza, ‘Commercial Banks to face higher capital requirements’ *The Daily Monitor* November, 30 2016.

²⁴⁹ Ibid.

insurance sectors.²⁵⁰ It researches and coordinates initiatives on Islamic finance related issues and organizes seminars and conferences for regulators and industry stakeholders.²⁵¹ Unlike the BCBS which relies on regulatory frameworks and best practices developed by leading banks as a background to its global framework; the IFSB has the task of developing on its own mind, the framework specifically for Islamic banks.²⁵²

The Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI)

This is an Islamic international autonomous non-profit corporate body that determines accounting, auditing, governance, ethics and *Shari'ah* Standards for Islamic Financial Institutions. Its mandate is to develop accounting and auditing principles relevant to Islamic finance, disseminate the said developed principles through training, seminars, publication as well as reviewing and amending accounting and auditing standards for Islamic financial institutions. All these objectives are carried out in conformity with the precepts of Islamic *Shari'ah*.²⁵³

4.2. Legislative Challenges For Islamic Bank In Uganda

Islamic finance is alien to Ugandan laws and it is only one Act that specifically provides for it albeit deficiently. Prudential regulation of banks is as imperative and required in Islamic banking as it is in conventional banking.²⁵⁴ The risks of Islamic banking are fundamentally related to financial intermediation.²⁵⁵ Subsequently, the objectives of prudential regulation and supervision to Islamic banking are similar to those of conventional banks: namely to pursue and maintain financial stability and avoid distress by ensuring the

²⁵⁰ See <http://www.ifsb.org/> (last accessed on August 9, 2017).

²⁵¹ *ibid.*

²⁵² Rifaat Ahmed, Abdel Karim, Simon Archer. '*Islamic Finance; The New Regulatory Challenge*'. Wiley Publishers. Pg 8.

²⁵³ See <http://aaoifi.com/objectives/?lang=en> (accessed August 11, 2017)

²⁵⁴ Errico, Luca, and Mitra Farrahbaksh, 1998, "Islamic Banking: Issues in Prudential Regulation and Supervision," IMF Working Paper 98/30 (Washington: *International Monetary Fund*)

²⁵⁵ *Ibid*

safety and soundness of banks, thereby preventing problems from having systemic consequences.²⁵⁶

As earlier discussed, public confidence in banks wanes when there is distress in the banking sector and this in turn is detrimental to both financial stability and inclusion. Thus it is paramount that the regulatory framework for Islamic banking should be fashioned to avoid undermining the stability of the financial system. Key elements to achieve this objective include: i) understanding the nature of Islamic banking activities, ii) making appropriate changes to the existing regulatory framework for Islamic banking, and iii) leveling the playing field between Islamic banking and conventional banking.²⁵⁷ The regulatory challenges wedged against Islamic finance's pursuit for financial inclusion and economic stability are as follows:

4.2.1. The Financial Institutions Amendment Act 2016

This specifically provides for and has encapsulated principles related to Islamic finance into the banking sector regulatory framework. It provides for the requirements needed to acquire a license before operating as a financial institution, the liquidity maintenance ratios, and limitations on some transactions a bank cannot engage in. It also establishes the Credit Reference Bureau and reforms the Deposit Protection Fund. This section analyses whether this piece of legislation and its regulations enable Islamic banking foster economic stability and inclusive growth.

Eligibility to acquire licence

Section 4(1) of the FIA provides that a person shall not transact any deposit-taking or other financial institution business in Uganda without a valid licence granted for that purpose under the Act and section 115A(1) states that a financial institution in Uganda may not operate as an Islamic bank without acquiring license from BoU.

Section 4(2) of the FIA states that no person shall be granted a licence to transact business as a financial institution unless it is a company within the meaning of the Act. Also Section 1 of the FIA, 2016 defines an Islamic financial institution as a company licensed to carry on

²⁵⁶ Inwon Song, op cit (n232)

²⁵⁷ *ibid*

financial institution business in Uganda whose entire business comprises Islamic financial business and which has declared to the Central Bank that its entire operations are and will be conducted in accordance with the *Shari'ah*.

The implication of this definition is that an Islamic bank can only be eligible to acquire license to operate as a financial institution only if it is a company. This presents a challenge since the concept of a corporate personality²⁵⁸ is not acceptable in Islamic *Shari'ah*.²⁵⁹ The rationale as to why there is no corporation in Islam is that, it is natural persons who have connection and thus are answerable to God for their deeds.²⁶⁰ While contemporary corporate law theory postulates that a company has an artificial personality responsible for its own deeds²⁶¹ this theoretical constructs on responsibility of a company is antithetical to Islamic philosophy as the company has no faculty of mind as an individual person.²⁶² This non-physical existence is reechoed in the famous oft-quoted words attributed to Lord Chancellor Baron Thurlow in the late eighteenth century that , “*a company has no soul to damn and no body to kick*”.²⁶³

However, in critique, the proponents of this line of thought are misguided. If a company wrongs someone, the veil of incorporation can be lifted to hold its controllers answerable/accountable. This principle of veil lifting states that although the corporate personality of a company is sacrosanct, it can nonetheless be lifted if it has been grossly abused.²⁶⁴ Therefore this should not be held as a hindrance but it nonetheless is by some people.

²⁵⁸ Rehana. Cassim in her text ‘Contemporary Company Law’ 2nd Edition JUTA at page 31, states that at the heart of company law is the corporate personality doctrine. This concept dictates that a company as a legal person is distinct from its shareholders and directors.

²⁵⁹ Kuran, T. (2005, Fall). The Absence of the Corporation in Islamic Law: Origins and Persistence. *The American Journal of Comparative Law*, 53 (4). pp. 785-834.

²⁶⁰ *ibid*

²⁶¹ *Salomon v A. Salomon and Co. Ltd* [1897] AC 22

²⁶² Kuran, T. *op cit* (n259)

²⁶³ This statement does not appear in any of his reported judgments and has not been tracked to a primary source but has however been adopted by leading scholars such as Farouk Hi Cassim, Maleka Femida Cassim Jacqueline Yeats in *Contemporary Company Law* at page 31. Published by JUTA. Also see Commissioner for Inland Revenue V Richmond Estates PTY Ltd 1956.

²⁶⁴ *Cape Pacific Ltd v Lubner Controlling Investments PTY Ltd* 1995(4) SA 790, Hulse –Reutter V Godde 2001 (4) SA 1336 (SCA).

Maintenance of liquid assets ratios

Liquidity refers to the degree of flexibility that an asset can be converted into cash quickly and easily without affecting the asset's value.²⁶⁵ It is the ability to sell an asset and convert it into cash, at a price equal or close to its true value, in a short period of time; the 'moneyness' of an asset.²⁶⁶ Section 28 (1) of FIA provides that a financial institution shall maintain a minimum holding of liquid assets, as determined by the Central Bank. This section makes it mandatory that all banks including Islamic banks should maintain liquid assets at levels which the BoU prescribes indiscriminately.

Islamic *Shari'ah* prohibits dealing in most of liquid assets and therefore a significant number of Islamic bank's assets are kept in the form of illiquid assets.²⁶⁷ The most liquid of assets is money and Islamic Banks as seen in the previous chapter do not deal with money but with assets which is the very fabric of Islamic Financing.²⁶⁸ These liquid assets yield returns in the form of interest (*riba*) which is in direct contravention with the *Shari'ah law*.²⁶⁹ There is no objection to investing in liquid assets however, the returns earned on these liquid assets should be in conformity with the *Shari'ah* which is not possible under this Act's operation.

Banks Liquidity Measuring and Monitoring

Further, when it comes to measuring and monitoring liquidity of banks- a function governed by the Financial Institutions (Liquidity) Regulations, 2005- the fact that Islamic banks cannot be as liquid as conventional banking is not considered. This is because while the latter deals mainly in cash, the former mainly deal with assets as discussed in the

²⁶⁵ Leonard Matz, Peter Neu, '*Liquidity Risk Measurement and Management: A Practitioner's Guide to Global Best Practices*' Wiley Publishers. At page 4.

²⁶⁶ Mushtak Parker 'Islamic banks face liquidity challenges' available at <http://www.iefpedia.com/english/?p=201> (accessed on August 9, 2017)

²⁶⁷ Mzee Mustafa Mzee. 'The Legislative Challenges of Islamic Banking in Tanzania' *Journal of Law, Policy and Globalization*. ISSN 2224-3210. At page 134.

²⁶⁸ Mushtak Parker op cit (n266)

²⁶⁹ Suleman, Yasser. The legislative challenges of Islamic banks in South Africa. Diss. Stellenbosch: Stellenbosch University, 2011.

previous chapter. Assets are less liquid compared to cash.²⁷⁰ The effect of this regulation is like the effect of Section 28 (1) of FIA as has been discussed above.

Deposit Protection Fund

Section 108(1) of the FIA establishes the Deposit Protection Fund which is controlled and managed by the Central Bank.²⁷¹ Monies paid into the Deposit Protection Fund are contributed by banks in order to secure their customers in case those banks are distressed and fail consequently being resolved.²⁷² When this occurs, the Fund pays back to the bank an amount which is higher than that which had been earlier on contributed by the banks as a result of interest. This is seen under section 108(6) of the FIA which provides that money constituting the Fund shall be placed in an account with the Central Bank to be invested in such manner as it deems appropriate and any income from the investment shall be credited to the Fund.

These sections present a problem since deposit insurance involves the exchange of money for money and the exchange occurs on an interest-based transaction and therefore contrary to Islamic values.²⁷³ The interest element could also exist if the Protection Fund monies are invested in interest-based transactions or other ventures considered immoral and not approved by Islamic *Shariah* thus *haram*.²⁷⁴ The profit would be viewed as not permissible and thus tainted in *sin* to be applied in refunding an Islamic bank when it has closed.²⁷⁵

Risk Management through Credit Reference Bureaus.

The FIA 2016 also introduces the Credit Reference Bureaus concept under sections 26, 78A which make it mandatory for banks to conduct credit checks on all customers applying to them for credit. It also mandates banks under section 78 (2)(a) to report to the

²⁷⁰ Mzee Mustafa Mzee. op cit (n267)

²⁷¹ Section 108(2) of the FIA

²⁷² section 108(3) of the FIA

²⁷³ Iqbal, Munawar, Auşāf Aḥmad, and Tariqullah Khan. 'Challenges facing Islamic banking'. *Islamic Research and Training Institute*, 1998.

²⁷⁴ *ibid*

²⁷⁵ *ibid*

Credit Reference Bureau all Non-Performing Loans classified as doubtful or loss in their portfolio.

This is meant to provide prudential guidance to banks on whether an applicant has in the past failed in his obligation to pay and is otherwise un-creditworthy. This compulsory procedure impairs the Islamic banks from disbursing credit even though as seen in the previous chapter, creditworthiness is not significant requirement for one to access credit in Islamic finance.

This is because although an applicant may not be creditworthy and with no property to use as collateral security, if their proposed project is economically promising they may succeed in securing a loan from an Islamic bank yet fail to secure an ordinary bank loan for their project. This would promote deeper financial inclusion status in Uganda and ease access to credit and encourage productivity and real economic activity. This requirement does not capture the primary expectations of Islamic banking in the loan client since the Islamic bank does business in a partnership with a client it is not much interested in the latter's creditworthy but rather whether their proposed venture has high prospects of success.

Limitation to invest on equity and assets

Directives on this aspect are obtained from The *Financial Institutions (Limits on Credit Concentration and Large Exposures) Regulations, 2005*. The main objective of these Regulations, among others, is to prescribe limits for investment in equity and fixed assets.²⁷⁶ Investment and trade in assets and equities in Islamic banking cannot be separated as has been discussed throughout the paper. Assets are a critical and underlying basis for any Islamic banking business and money in Islamic banking is inferior to property; as such these limitations curtail its effective operation.²⁷⁷

²⁷⁶ Regulation 4 (1)

²⁷⁷ Mzee Mustafa Mzee. op cit (n267)

The BoU as lender of last resort

Like most, the BoU being a central bank, serves as banker and lender of last resort to commercial banks in times of liquidity crunches.²⁷⁸ This financing is done through the *Lombard window* facility at BoU.²⁷⁹ Lombard credit refers to granting of credit to banks by Central Banks against pledged collateral such as securities or insurance policies.²⁸⁰ The eligible collateral for borrowing BoU lending includes Government securities, corporate bonds, promissory notes and Bills of exchange, reserves with BoU, Cash assets warehouse warrants, balances with banks abroad, bank loans, fixed assets, and income producing and cash flow positive real estate.²⁸¹

Although the BoU supervises Islamic banks, Islamic banks cannot benefit from these loans as they are provided on the basis of interest that comes with repurchase agreements (the repo rate).²⁸² Since Islamic finance is anti *riba/interest*, then it is left out and thus when in distress, there may not be any saving grace for them under this system.²⁸³

Issues with Islamic Windows

There can be a few risks and challenges that are associated with Islamic banking windows. The mixing of Islamic windows' assets and liabilities with conventional banks could have consequential reputational risk, as depositors in windows might suddenly withdraw their money if rumors regarding commingling arise.²⁸⁴ This also raises concerns about consumer protection which may in turn lower client confidence in these banks which hurts financial inclusion as seen in chapter 2.

²⁷⁸ Section 29 (1)(e) of the BoU Act

²⁷⁹ See the Bank of Uganda Rules Governing the Lombard and the Rediscount Window. Available at https://www.bou.or.ug/bou/bou-downloads/Financial_Markets/Rules-Governing-the-Lombard-and-the-Rediscount-window.pdf (last accessed on August 10, 2017)

²⁸⁰ Mackenzie, K. W. S. "World economic outlook a survey by the staff of the International Monetary Fund International Monetary Fund, Washington DC. April 1985, 268 pp.; April 1986, 268 pp." (1987): 404-405.

²⁸¹ Further guidance on collateral eligible for borrowing from BoU beyond the standing facilities is the "Policy Paper on Levels of Collateral that Bank of Uganda Can Accept During a Financial Crisis" approved by BoU's Financial Stability Committee.

²⁸² Mackenzie, K. W. S, op cit (n280)

²⁸³ Also see: Gayane Oganessian, The Changed Role of the Lender of Last Resort: Crisis Responses of the Federal Reserve, European Central Bank and Bank of England, Institute for International Political Economy Berlin at pg. 2

²⁸⁴ Inwon Song, op cit (n232)

Furthermore, the Islamic windows could hinder the establishment of effective corporate governance and risk management systems because the management and board of a conventional bank may not be comprehensively acquainted with the peculiar risks associated with Islamic finance activities.²⁸⁵ Therefore, their ability to comprehend risks inherent with Islamic finance and supervise the risk management of the Islamic Banking window may be undermined.

There have been attempts at alleviating the above challenge through establishment of *Shar'iah* boards under section 115B of the FIA Act. However even these boards might not be able to verify the complete separation of assets and liabilities of the two respective types of banks' accounts.

The use of Islamic windows could further lead to regulatory arbitrage or unjust practices. For instance, by nature of the PLS concept of Islamic banking accounts, risky financing could be promoted to acquire Islamic financing through windows because, in the case of default, the account holders of Islamic windows will bear the losses.²⁸⁶ Likewise, securities holdings could be shifted between investment portfolios funded by conventional sources of funds and those financed by Islamic accounts for ease of returns.²⁸⁷

The Islamic windows could further obstruct effective financial oversight.²⁸⁸ This is because some prudential ratios that might vary for Islamic banking could be strenuous to monitor properly. Windows could also impede the preparation of proper financial statements for windows activities, thus obstructing effective oversight.

Further because of the commingling, there may be difficulty in resolution or rescue when a bank is in distress. This is because the issue of how distressed Islamic banks should be resolved in accordance with *Shar'iah* principles is still under deliberation and there has been no conclusive position to this effect.²⁸⁹ Consequently, it is submitted that if authorities are faced with a distressed conventional bank with an Islamic window, there may be difficulty in conducting an effective resolution or rescue in line with financial stability

²⁸⁵ Ibid

²⁸⁶ Ibid

²⁸⁷ ibid

²⁸⁸ Ibid

²⁸⁹ See IFSB "Islamic Finance and Global Financial Stability" April 2010.

objectives and *Shar'iah* law that could potentially alter the treatment of the Islamic banking window.

Therefore, Islamic finance's coexistence with conventional banking in the same institution could as seen either bring about stability and enhance financial inclusion or it could wreak havoc if not well regulated.

4.2.2. The Legal Concept of goods

As seen, provision of finances to clients by Islamic banks is largely based on the sale of goods to clients on credit. For example under the *Murabaha* mode of finance, the bank procures goods or services and resells it to the client at a profit. The only laws that are greatly useful in Islamic banking in relation to goods are the Sale of Goods Act, Cap 82 and the Contracts Act 2010.

A few challenges, however, against these laws are: Section 1(h) of the Sale of Goods Act defines goods as all chattels personal excluding things in action and money, emblements, industrial growing crops, and things attached to or forming part of the land, which are agreed to be severed before sale or under the contract of sale and by this a contract of sale involving the things excluded is not acceptable. This definition is *pari materia* with the definition of goods under the Contract Act.²⁹⁰

In Islamic banking, the '*bai salam*' mode of financing is mainly used for sales of goods such as crops which have not been planted or harvested from the farm. Such is not recognised as goods that can be sold under the Sale of Goods Act and Contract Act.²⁹¹ Under '*bai salam*' the fact that one can sell crops even before he has planted them is not possible under Uganda's contract law regime. Under section 23 of the Contract Act, an agreement on this kind of transaction is void for uncertainty.

Further, under Section 28 of the same law, it is referred to as a contingent contract and is unenforceable. A contingent contract is a contract to do or not to do something, where an event, collateral to such contract, does or does not happen.²⁹² For instance, under Islamic law a farmer may receive funds from an Islamic bank to cultivate crops and in turn sale the

²⁹⁰ The law relating to the sale of goods is governed by Part VII of the Contract Act 2010

²⁹¹ Yasser Suleman (2011) '*The Legislative Challenges of Islamic Banks in South Africa Research*' report presented in partial fulfillment of the requirements for the degree of Master of Business Administration at the University of Stellenbosch (Unpublished)

²⁹² Section 2 of the Contracts Act

harvest and pay the bank its due. This fact makes the contract contingent upon availability of such crops which is uncertain and thus unenforceable.

4.2.3. Double taxation with respect to sales modes transactions

The emergence of Islamic finance raises issues relating to payment of stamp duty fee. The fee is pertinent to the value of real property or a financial agreement and is mostly charged as a standard part of conventional commercial banking and in business practice.²⁹³ Section 2 of the Stamps Act, Cap 342 provides that every instrument mentioned in the Act's schedule is executed in Uganda or if executed outside Uganda, relates to any property in Uganda or to any matter to be performed shall be chargeable with the duty of the amount indicated in that schedule in relation to such instrument.

The challenge arises in purchase and resale agreements associated with some Islamic financing. Usually stamp duty is paid when the ownership in the asset is transferred.²⁹⁴ So the buyer must pay this over and above the purchase price paid to the seller. With Islamic sales, however, the bank buys the property instead and then resells it to the client with an appropriate mark-up.²⁹⁵ The taxation problem is; these two transactions would normally incur two separate stamp duty payments.²⁹⁶ What is disregarded is that this is only one financing arrangement but that two transactions are needed to achieve the desired outcome. Thus while the interest a conventional bank receives is regarded as a 'passive' income, profit received by Islamic bank is regarded as an earned income which is treated differently for purposes of tax hence paying twice.²⁹⁷ In addition, in trade financing there are title transfers twice, once from seller to bank and then from bank to buyer and therefore both these transactions are twice taxed. This increases the cost and thence decreases the profitability of the venture.²⁹⁸

²⁹³ Mzee Mustafa Mzee. op cit (n267)

²⁹⁴ Section 3 of the Stamps Act, Cap 342

²⁹⁵ Khan, M., & Bhatti, M. (2006). Why Interest-free Banking and Finance Movements Failed in Pakistan. *Humanomics* 22

²⁹⁶ *ibid*

²⁹⁷ *ibid*

²⁹⁸ Basiru Oyeniran Fatai, 'Can Islamic Banking Work In Nigeria?' *Journal of Sustainable Development in Africa* (Volume 14, No.2, 2012).

4.2.4. Jurisdiction of the Court in Uganda in Islamic banks disputes

Article 138 of the Ugandan Constitution states that there shall be a High court of Uganda and article 139 provides this court with original and unlimited jurisdiction.²⁹⁹ The High Court has divisions among which is the commercial division. This handles matters of a commercial nature such as companies and banks.³⁰⁰ Regulation 4(1) of the Constitution (Commercial Court) (Practice)(Directions) S-1 Constitutional 6 states that the business of the commercial court shall comprise of all actions arising out of any relationship of a commercial or business nature including banking. As Islamic banks disputes fall under the same purview, all disputes arising out of Islamic bank transactions will be subject to the same procedure and process as experienced by its conventional counterpart. This can lead to ill delivered judgments since Islamic banking has some technical aspects different from those of the conventional one. These require judicial officers to be well versed with them before forming an informed decision. However Islamic banking being a new phenomenon in Uganda, it is highly unlikely that the judges are well acquainted with its legal aspects.

Therefore given its technical difference from conventional banking, Islamic finance should adopt tried and tested framework for execution of commercial and financial contracts and transactions as used in other countries where it has registered remarkable success. It is necessary that the available laws be amended and new ones introduced on top of other institutions to overlook Islam finance if it is to thrive in Uganda and build the economy.

²⁹⁹ Also provided for by section 133(1)(b) of the Judicature Act Cap 13

³⁰⁰ The High Court Commercial Division was created by Legal Notice No 5 of 1996 which was codified in the Constitution (Commercial Court) (Practice) Directions S-I 6

CHAPTER FIVE

5. RECOMMENDATIONS AND CONCLUSION;

5.1. Lessons from Malaysia.

The Ernst and Young World Islamic Banking Competitiveness Report 2016 ranks Malaysia as a leading Islamic finance powerhouse globally.³⁰¹ Islamic finance has been a priority area in Malaysia for three decades with promulgation of Islamic fitting laws. In 2013, it enacted a comprehensive Islamic Financial Services Act to consolidate Islamic financial sector regulations, improving *Shari'ah* governance, properly differentiate Islamic deposit taking from investment activities, and provide relevant regulations for both.³⁰² These efforts foster proper risk sharing between the financial institutions and their clients. The Act further graces the responsibility of overall supervision with the Central Bank of Malaysia; the Bank Negara Malaysia (BNM).³⁰³ The BNM was established under the Central Bank of Malaysia Act 1958 which is currently amended by the Central Bank of Malaysia Act 2009.³⁰⁴ Lessons and recommendations to take away from their banking law regime in aid of a young Ugandan Islamic law banking sector include the following.

5.1.1. Liquidity Measurement Adjustments

From the aforementioned challenges, a pattern can be seen throughout the regulations and guidelines and that is, most regulations that are currently being used by the BoU in supervising banks are not appropriate for Islamic banking. This is because Islamic banking has new technicalities different from those of the conventional banks. For instance, the challenges relating to liquidity requirements and adequacy of capital in banks depend on an assessment of the value of assets of the individual banks.³⁰⁵ Since there is variation in assets held by the different types of banks due to their *modus operandi*, then

³⁰¹ Ernst & Young, op cit (n40)

³⁰² Act 759 Laws of Malaysia, whose long title is, “*An Act to provide for the regulation and supervision of Islamic financial institutions, payment systems and other relevant entities and the oversight of the Islamic money market and Islamic foreign exchange market to promote financial stability and compliance with Shari'ah and for related, consequential or incidental matters*”.

³⁰³ Section 6

³⁰⁴ Section 3 of Act 701, Laws of Malaysia whose long title states that, “*An Act to provide for the continued existence of the Central Bank of Malaysia and for the administration, objects, functions and powers of the Bank, for consequential or incidental matters*”.

³⁰⁵ Mzee Mustafa Mzee. op cit (n267)

applying the one-size-fits-all approach will yield discriminate results as the considered percentage of risk weighted assets (RWAs) may also be different.³⁰⁶

In Uganda as seen above, the BCBS capital framework applies to all banks as there is no distinction between the capital requirements that apply to Islamic financial institutions and those that regulate the conventional ones. This is not the case in Malaysia which pursues the mixed approach where a similar regulatory framework is adopted for areas that are applicable to Islamic and conventional banks, but separate guidelines and regulations are issued for areas that are specific to Islamic banking.³⁰⁷ That is, in Malaysia, the BCBS capital framework is complemented by the guidelines of the IFSB, custom made for Islamic banking. Following the revamping of the Basel Capital Accord in 2005, the IFSB issued two regulatory standards on capital adequacy and risk management for Islamic institutions.³⁰⁸ Therein, IFSB supervisory discretionary formula was proposed for Capital Adequacy Ratio (CAR) and can be expressed as;³⁰⁹

“CAR= [Eligible Capital]/{[total risk-weighted assets + operational risk]-[RWAs funded by restricted profit sharing investment accounts (credit + market risk) – [(1- α^) total risk-weighted assets funded by unrestricted profit sharing investment accounts] – [α^* risk-weighted assets funded by Profit Equalization Reserves and Investment Risk Reserves of unrestricted profit sharing investment accounts]}}, where α^* is the proportion of assets funded by Profit Sharing Investment Accounts and is determined by the supervisory authorities”³¹⁰*

³⁰⁶ Risk-weighted asset is a bank's assets or off-balance-sheet exposures, weighted according to risk. This sort of asset calculation is used in determining the capital requirement or Capital Adequacy Ratio (CAR) for a financial institution. Under Basel III, banks should hold enough capital to equal at least 8% of risk-weighted assets.

³⁰⁷ Inwon Song, op cit (n232)

³⁰⁸ See the IFSB's guidelines “Capital Adequacy Standards for Institutions (Other than Insurance Institutions) Offering Only Islamic Financial Services” and “Guiding Principles of Risk Management for Institutions (Other than Insurance Institutions) Offering Only Islamic Financial Services”.

³⁰⁹ Inwon Song, op cit (n232)

³¹⁰ IFSB issued in March 2011, a guidance note with a methodology to estimate the value of alpha to be used in the supervisory discretion formula

Therefore although discretionary, the BoU is advised to adopt this same formula for Islamic banks in relation to liquidity measurements for a fair criteria that fosters Islamic banking growth.

5.1.2. Application of Alternative Dispute Resolution

For an expedient and efficient supporting Islamic legal system, there is need to train judicial officers, lawyers and other officers of court about the intricacies of Islamic law. However, in the meantime, it is crucial to use Alternative Dispute Resolution (ADR) in solving any dispute which emerged from the Islamic banks in Uganda.

ADR firstly is a highly encouraged practice in Islam³¹¹ and has been practiced since the advent of *Shari'ah* law over fourteen centuries ago.³¹² Another reason why ADR is a suitable mechanism is that through the mediation and arbitration modes, the parties can employ an Islamic bank expert to facilitate their resolve or arbitration. This would overcome the challenge arising from the lack of acquainted personnel in the courts of law. Further, this mode is beneficial to both parties to the dispute as it may save time wasted in court litigating and also can foster confidentiality if the would be litigants do not wish to wash their linen in public.

In Malaysia, ADR is prevalent and the Central Bank's *Shari'ah* board has overall authority over *Shari'ah* issues arising out of banking and finance as the final arbiter in disputes on such issues.³¹³ Section 51 of the Central Bank of Malaysia Act 2009 establishes a *Shari'ah Advisory Council* and its ruling is not only binding but can be used as precedence by courts of law.³¹⁴

The same is recommended for Uganda. This would bequeath the BoU *Shari'ah* advisory board legislative and adjudicative powers ensure quick, proper and informed decision making. If the members of BoU *Shari'ah* Board make good decisions, this could also create

³¹¹ The Quran at Surah 4, verse 35, "If you fear a breach between them twain (the man and his wife), appoint (two) arbitrators, one from his family and the other from hers; if they both wish for peace, Allah will cause their reconciliation. Indeed Allah is Ever All-Knower, Well-Acquainted with all things."

³¹² Blazing The Trail: The Institutional Framework for Dispute Resolution in Malaysia's Islamic Finance Industry Umar A. Oseni and Abu Umar Faruq Ahmad.

³¹³ Section 57 of the Central Bank of Malaysia Act 2009.

³¹⁴ Section 56(2) of the Central Bank of Malaysia Act 2009.

a wealth of Islamic finance jurisprudence for the court's guidance through this new nascent phenomenon.

5.1.3. Exemption from Double Taxation

To remove tax discrimination between the application of conventional instruments and Islamic instruments, Malaysia made different amendments to its legislation regarding tax treatment of Islamic finance.

Under amendments to the Malaysian Income Tax Act 1967, Section 2(8) provided that

“...any reference in this Act to the disposal of an asset or lease by or to a person pursuant to a scheme of financing approved by the Central Bank...as a scheme in accordance with the principles of Shari’ah where such disposal is strictly required for the purpose of complying with those principles but which will not be required in any other schemes of financing”.

This implied that the Act allowed Islamic financing to continue without any tax issues relating to asset transfer or lease whilst though not evading taxes.³¹⁵

Further the Malaysian Stamp Act 1949 has been amended by a variety of exemption orders for different transactions. These exempted from stamp duty on all instruments of *Ijara* lease agreement of immovable property executed between a client and a bank pursuant to the *Ijara* term financing facility;³¹⁶ instruments of asset sale agreements between client and bank made under principles of *Shari’ah* for the purpose of renewing any Islamic overdraft financing facility;³¹⁷ and like instruments that related to purchase of property for the purpose of lease back under *Shari’ah* principles.³¹⁸

As analyzed in the previous chapter, Uganda’s tax regime if not amended will chock Islamic banking growth at the incipient stage. There is thus urgent need for modification of the tax

³¹⁵ Section 2(7) also provided an amendment that, *“any reference to interest shall apply, mutatis mutandis, to gains or profits received and expenses incurred, in lieu of interest, in transactions conducted in accordance with the principles of Shari’ah”.*

³¹⁶ Stamp Duty (Exemption) (No.8) Order 2000

³¹⁷ Stamp Duty (Exemption) (No.9) Order 2000

³¹⁸ Stamp Duty (Exemption) (No.3) Order 2000

laws to exempt the Islamic banks from double taxation on assets they acquire for financing purposes.³¹⁹

5.1.4. Separate Deposit Protection Fund

Malaysia has implemented a binary deposit insurance system following the September 2005 enactment of the Malaysia Deposit Insurance Corporation Act (MDIC Act)³²⁰. Malaysia's Islamic deposit insurance system operates separately from the conventional system, but both systems are administered solely by the Malaysia Deposit Insurance Corporation (MDIC).³²¹

This makes it easy to determine which money belongs to either bank and as such, money can be invested in *Shari'ah* compliant liquid assets until they are required.³²²

Therefore in times of distress, the money appropriated for Islamic banks in the deposit protection fund can be used to revive a distressed Islam financial institution and nurse it back to normal health as a going concern

There is a need for creating other forms of returns to the BoU so that Islamic banks can benefit from loans granted by the Central Bank when in danger. The importance of this cannot be understated. In his text, "Lombard Street: A Description of the Money Market" (1873), Walter Bagehot postulates that unlike commercial banks, the role of the Central Bank is peculiar because it is the holder of liquid reserves. Therefore, when commercial banks encounter illiquidity or financial distress, the Central Bank has the capacity and duty to lend the commercial banks to satisfy liquidity demands. If BoU keeps a separate Fund that is interest free then in times of need, it can lend to the Islamic bank.

³¹⁹Also see. Basiru Oyeniran Fatai,' *Can Islamic Banking Work In Nigeria?*' Journal of Sustainable Development in Africa (Volume 14, No.2, 2012).

³²⁰ Now amended and cited as 'Malaysia Deposit Insurance Corporation (Amendment) Act 2015'.

³²¹ Section 3 states that, "*there is hereby established a body corporate by the name of "Malaysia Deposit Insurance Corporation" with perpetual succession and a common seal, and which may sue and be sued in its corporate name.*"

³²²Mzee, Mzee Mustafa. "The Legislative Challenges of Islamic Banking in Tanzania." *JL Pol'y & Globalization* 45 (2016): 131.

5.1.5. Twin Peaks model of financial regulation.

Lastly is a proposal not from the Malaysian context but one the author is inclined to recommend as necessary for economic stability and successful supervision of Islamic finance and Uganda's banking sector at large. This is based on the findings made throughout this paper and mainly those of the Judicial Commission of Inquiry instituted in January October 2000 to investigate the cause of the frequent collapse of banks. The commission chaired by Justice James Ogoola upon concluding its investigation found that weak supervision by the BOU was a major cause of these bank failures.³²³ There had been laxity in decision making and the bank had not actively used its intervention powers at the early detection of distress by banks which was reiterated by the IMF.³²⁴ In light of this, the 'Twin Peaks Model of financial regulation' is recommended. This mode of financial regulation calls for the separation of the financial stability role to be administered by a one department and the supervision of banking practice and consumer protection mandate to be exercised by another department/regulator.³²⁵ The first peak, the Financial Stability Commission, would ensure that there are adequate and sufficient prudential measures to ensure soundness of the financial system, capital adequacy of banks and control of risk. The second peak, the Consumer Protection Commission, would enforce business conduct regulations to ensure that customers received a fair, honest and transparent service.³²⁶ This model has been applied by Australia, Netherlands, the UK and its off-shoots can be found in South Africa,³²⁷ Spain and Canada.³²⁸

³²³ Ingves, Stefan, and Abdoulaye Bio Tchané. 'Uganda: Financial System Stability Assessment, Including Reports on the Observance of Standards and Codes on the Following Topics: Monetary and Financial Policy Transparency, Banking Supervision, Securities Regulation, Insurance Regulation, Corporate Governance, and Payment Systems.' (2003).

³²⁴ See IMF Country report, *Uganda: Financial System Stability Assessment, including Reports on the Observance of Standards and Codes on the following topics: Monetary and Financial Policy Transparency, Banking Supervision, Securities Regulation, and Payment Systems* at pg. 38 (10/4/03), Washington, D.C.

³²⁵ Michael Taylor, "Twin Peaks: A Regulatory Structure for the New Century". Issue 20 of Centre for Study of Financial Innovation Series, 1995.

³²⁶ Ibid

³²⁷ Under the newly promulgated Financial Services Regulation Act, 2017.

³²⁸ For a general discussion on Twin Peaks model and the various regulatory systems see Richard J. Herring & Jacopo Carmassi *The Structure of Cross-Sector Financial Supervision* Wharton School, University of Pennsylvania (unpublished) at pg. 10, accessed via <http://fic.wharton.upenn.edu/fic/papers/07/0734.pdf> (last visited on 23rd Sept 2015).

The introduction of Islamic finance in Uganda has widened the scope of financial industry and as such silo regulation has become untenable.³²⁹ A proposal for a twin peak system in Uganda is essential especially in the wake of the BoU's struggles with supervising national banks.³³⁰ This would help reduce the load of responsibility the BoU has and instead of focusing on the whole economy, direct its attention on prudent supervision of Islamic banks and the sector at large.

5.2. Conclusion: Uganda, An Aspiring Dual System.

In a nutshell, while Islamic banking and finance is expected to remarkably contribute to inclusive economic growth and development in Uganda, it remains an emerging field in the financial system. Therefore, all stakeholders must first clearly acquaint themselves with the intricacies of Islamic finance modes; apprehend its unique tenets that distinguish it from conventional banking while also acknowledging the similarities between the two models. This will significantly contribute to the effective rollout and growth of the Islamic banking sector in Uganda.

First and foremost, before guidance is issued on the regulatory nature of Islamic banking, care should be made to exercise proper corporate governance by the individual institutions. This is for two main reasons; one is the significant inherent opacity of the balance sheet of banks which makes it hard to assess the quality of the assets that a bank holds and subsequently its true financial position.³³¹ Secondly, the potential ripple effects of bank failures are very disastrous to the country's economy as was clearly exhibited by the

³²⁹Silo regulation means a regulatory framework based on supervision and regulation of according to industries, such as separate regulators for banking, insurance, securities and pensions. This differs from Twin Peaks in the sense that the peaks model regulates according to function, such as consumer treatment and systemic risk management. Silver Kayondo, "*Legal aspects of distressed bank rescue: Lessons for Uganda from the South African and English experience*" dissertation presented in fulfillment of the requirements for the degree of Master of Laws (Banking and Finance) at the University of Pretoria. Page 59

³³⁰ During the closure of Crane Bank, the BoU Governor admitted that they discovered "too late" that the bank had been involved in fraud, for lack of a better word, involving theft of depositors' money. See Ivan Okuda, 'Museveni okayed Crane Bank closure- Mutebile' *The Daily Monitor* available at <http://www.monitor.co.ug/Business/Museveni-okayed-Crane-Bank-closure-Mutebile/688322-4040962-32d9b0/index.html> (accessed on August 14, 2017)

³³¹ Governor Emmanuel Tumusiime-Mutebile address to the Kenya Commercial Bank (KCB) Board of Directors Retreat held at Kampala on 2/11/2012 entitled, "Corporate Governance and banking regulation in Uganda".

global financial crisis in 2007/8. Plus it should be remembered that no amount of legislative regulation can save a bank whose owners run it poorly.

On the regulatory front, financial inclusion by Islamic finance is likely to be hampered by the lack of a harmonized financial regulation structure. As discussed before, discriminate policies in taxation, liquidity measurements and standards, and limitations to invest in equity and assets constitute a major challenge for the Islamic finance industry. They constrain it in its efforts to provide credit and improve financial inclusion and develop the economy at large.

Globally accepted prudential standards passed by the IFSB that smoothly blend Islamic finance with the conventional financial system need to be adopted by the BoU. For example, the adoption of the IFSB Standards (somewhat akin to Basel III) which take into account the specificities of Islamic finance, secure a level playing field between the two types of banks.

In addition to micro- prudential regulation, there is call for the two peak system. This model has been applied by Australia, Netherlands, the United Kingdom and under is under debate in South Africa,³³² Spain and Canada.³³³ The focus on macro-prudential policy is inspired by the fact that micro-prudential regulation although essential, it is not a comprehensive deterrent to systemic risk.³³⁴ Micro-prudential regulation (such as the Basel I and II capital accords) tends to view financial institutions in isolation and aims mainly to ensure that each is individually solvent.³³⁵

From the aforementioned, one thing is clear and that is all stakeholders, from the customers to the banks and regulatory authorities, there must be joint effort in kick starting Islamic Banking especially at this incipient stage. As discussed, because of its interest-free nature among other qualities, it has the potential to lower the cost of accessing credit which is a major challenge to financial inclusion.

³³² Proposed in the Financial Services Regulation Bill

³³³ For a general discussion on Twin Peaks model and the various regulatory systems see Richard J. Herring & Jacopo Carmassi *The Structure of Cross-Sector Financial Supervision* Wharton School, University of Pennsylvania (unpublished) at pg. 10, accessed via <http://fic.wharton.upenn.edu/fic/papers/07/0734.pdf> (last visited on 23rd Sept 2015).

³³⁴ Silver Kayondo, “*Legal aspects of distressed bank rescue: Lessons for Uganda from the South African and English experience*” dissertation presented in fulfillment of the requirements for the degree of Master of Laws (Banking and Finance) at the University of Pretoria. Page 59

³³⁵ Viral V Acharya *Systemic Risk and Macro-Prudential Regulation* New York University Stern School of Business, Center for Economic Policy Research & National Bureau of Economic Research (2011) at pp.3-5.

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